TAX SHELTERS, ACCOUNTING ABUSES, AND CORPORATE AND SECURITIES REFORMS

HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

NINETY-EIGHTH CONGRESS

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TAX SHELTERS, ACCOUNTING ABUSES, AND CORPORATE AND SECURITIES REFORMS

WEDNESDAY, FEBRUARY 22, 1984

House of Representatives,
Committee on Ways and Means,
Washington, D.C.

The committee met at 10 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

[The press releases announcing the hearings follow:]

[Press release No. 19, Wednesday, Feb. 1, 1984]

Hon. Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, Announces Hearings on Administration and Other Proposals Concerning Tax Shelters, Accounting Abuses, and Corporate and Securities Reforms

The Honorable Dan Rostenkowski, (D. Ill.), Chairman of the Committee on Ways and Means, U.S. House of Representatives, today announced the Committee will hold a two-day public hearing on Administration and other proposals concerning tax shelters, accounting abuses, and corporate and securities reform. The hearing will be held on Wednesday, February 22, and Tuesday, February 28, 1984, beginning at 10:00 a.m. each day in the Committee's main hearing room, 1100 Longworth House Office Building.

The Committee will receive testimony from the Administration on Wednesday, February 22, and from Members of Congress and the interested public requesting to be heard on Tuesday, February 28.

The Committee will solicit testimony on the following Administration proposals, which are included in the President's Fiscal Year 1985 Budget:

Partnership and other tax-shelter related proposals.—The President's budget contains proposals intended to restrict tax shelter activities and prevent taxpayers from claiming unintended tax benefits. Tax shelter techniques addressed by the proposals involve certain partnership, partnership distributions, like-kind exchanges of partnership interests and the treatment of market discount on bonds.

Accounting and time-value-of-money proposals.—The President's budget proposes changes to certain accounting provisions of the tax code so that the effects of interest rates and inflation will be more properly taken into account for tax purposes. These proposals deal with deferred payments, prepayments of expenses, interest-free loans, LIFO conformity, premature accruals, and certain securities transactions.

Corporate and security-related reform proposals.—The President's budget includes proposals that would limit unintended tax benefits available to corporations and their shareholders. The proposals deal with the taxation of corporate distributions, the treatment of investment companies, mutual fund distributions, collapsible corporations, and certain foreign transactions.

Other proposals.—In addition, the Committee invites testimony on proposals to deal with other provisions in the tax which may have unintended tax benefits including alternative solutions to problems addressed by the Administration's proposals. Additional areas will include tax-motivated transactions in Treasury bills, deductions allocable to tax-deferred income, recent tax-motivated employee compensation arrangements, additional corporate reforms, and partnership allocations.

The Committee wishes to emphasize that the scope of these hearings will not include those proposals that have previously been considered by the Committee or its

Subcommittees such as those dealing with the tax treatment of options which were considered in the November 2, 1983, hearing on the taxation of capital gains or the offshore commodity proposals included in H.R. 4170.

Detailed descriptions of all the proposals listed above will be presented in a hearing pamphlet which will be made available to the public prior to the Administration's testimony on February 22.

In announcing the hearings, Chairman Rostenkowski stated, "The Administration has made some constructive proposals to deal with tax shelters, accounting methods and corporate reforms. To the extent that abuses can be curtailed without unduly interfering with ordinary business transactions, Congress should act to reform the law. I hope these hearings produce a thorough discussion of the merits of the Administration proposals, along with other suggestions that have been made on the same and similar topics, to permit the Committee to make an informed judgment about the problems presented and the proposed legislative solutions."

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD

Individuals and organizations interested in presenting oral testimony before the Committee must submit their requests to be heard in writing no later than close of business Tuesday, February 21, 1984, to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. Notification to those scheduled to appear will be made by telephone as soon as possible after the filing deadline.

It is urged that persons and organizations having a common position make every effort to designate one spokesman to represent them in order for the Committee to hear as many points of view as possible. Time for oral presentations will be strictly limited with the understanding that a more detailed statement may be included in the printed record of the hearing. This process will afford more time for Members to question witnesses. In addition, witnesses may be grouped as panelists with strict time limitations for each panelist.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, witnesses scheduled to appear before the Committee are required to submit 200 copies of their prepared statements to the Committee office, room 1102 Longworth House Office Building, at least 24 hours in advance of their scheduled appearances. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

Requests to be heard must contain the following information:

1. The name, full address, and capacity in which the witness will appear, as well as a telephone number where he or his designated representative may be reached;
2. A list of any clients or persons, or any organization for whom the witness appears; and
3. A topical outline or summary of comments and recommendations.

The above information should also be incorporated in the prepared statements to be presented in person as well as those filed for the printed record of the hearing.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

Persons submitting written statements for the printed record of the hearing should submit at least six (6) copies by the close of business, Tuesday, March 6, 1984, to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements for the record of the printed hearing wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the Committee office before the hearing begins.

[Press release No. 19 (revised), Friday, Feb. 24, 1984]

HON. DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES A CHANGE IN TIME FOR THE HEARINGS ANNOUNCED ON ADMINISTRATION AND OTHER PROPOSALS CONCERNING TAX SHELTERS, ACCOUNTING ABUSES AND CORPORATE AND SECURITIES REFORMS

The Honorable Dan Rostenkowski (D., Ill.), Chairman of the Committee on Ways and Means, U.S. House of Representatives, today announced that the hearing scheduled for Tuesday, February 28, 1984, will begin at 9:30 a.m.

All other details as previously announced remain the same (see press release No. 19, dated February 1, 1984 and No. 19-Revised, dated February 15, 1984).

Chairman ROSTENKOWSKI. The committee will come to order.

Today, the Committee on Ways and Means opens 2 days of hearings on the administration's fiscal year 1985 budget proposals relating to tax shelters, accounting abuses, corporate and securities reforms, together with related proposals aimed at eliminating tax-motivated transactions.

Aggressive attempts to reduce or eliminate tax shelters are certainly not novel. As many of my colleagues on this committee will recall, we have enacted a number of similarly well-intentioned reforms over the years, beginning with the Tax Reform Act of 1969, and most recently with TEFRA in 1982. A number of important reform provisions are also included in H.R. 4170, which has been reported by this committee and awaits House floor action.

The committee welcomes the administration's support for the provisions of that bill. However, our hearings today and on February 28 will not reopen issues addressed in H.R. 4170.

Periodically, we perceive the risk that abusive tax shelters presents to our system. They rob our tax system not only of revenues, but also of its claim to fairness and hence public confidence. Moreover, the booming business of organizing and promoting tax shelters represents a drain on what might otherwise be productive use of our Nation's resources.

While not without their problems, the administration's proposals appear to be an important and reasonable starting point in the current effort to make our tax laws more equitable and rational by eliminating certain abuses and unintended tax benefits that have been identified in the present system.

In addition, it appears that the changes advocated by the administration may produce relatively significant revenues over the next few years. Thus, they take on added importance in the struggle to reduce the Federal deficit.

Therefore, we eagerly look forward to hearing the testimony of the administration today. However, there is some concern that these proposals as well as related or alternative proposals may have broad ranging and possibly unintended effects on taxpayers engaged in legitimate business transactions which are primarily not tax motivated.

Before the committee acts on any of these proposals, their effect must be further identified and explored. Refinements to avoid such unintended or undesirable impacts may be necessary. If such refinements are not possible, the committee may wish to reconsider the appropriateness of some proposals. Thus, the testimony that the committee will hear next Tuesday from Members of Congress and the public, if candid and constructive, should be extremely helpful in enabling us to make those decisions.

In this context, then, we welcome the Assistant Secretary of the Treasury for Tax Policy, Buck Chapoton. Buck, we look forward to your testimony. You may proceed in any manner in which you wish.

Mr. Conable, do you have an opening statement?

Mr. CONABLE. Mr. Chairman, I will be brief. Thank you for recognizing me.

The proposals which are the subject of today's hearings are important for a number of reasons. They represent an extension of efforts which this committee made in developing H.R. 4170, to prevent further erosion of the tax base. In some instances, that bill called for eliminating unintended or outmoded provisions of the Internal Revenue Code.

The particular provisions which have been suggested by the Treasury and which are being discussed today appear to be narrowly directed at practices where unintended benefits are being received or abuses are believed to exist.

The need to address these types of problems is generally important as a means of preserving confidence in, and the integrity of, our voluntary tax system. In the present context of a very large deficit, this need is all the more important, and the combination of these provisions could have an important impact on reducing shortfalls not only for this fiscal year but particularly for the future.

I do not necessarily endorse each one of the proposals put forward, but I do endorse this legitimate approach to deter further erosion of our tax base, and I commend the Treasury people for their hard work.

Mr. Secretary, we do look forward to hearing your testimony. Thank you for being here today.

Chairman ROSTENKOWSKI. Mr. Secretary, you may proceed.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. CHAPOTON. Mr. Chairman, Mr. Conable, I am happy to be here today to present the administration's position with respect to the area of tax shelters, accounting abuses, and certain corporate abuses. The ones I will mention today and covered in my written statement are the administration's proposals contained in the budget for fiscal 1985 and will increase revenues over the period 1985 through 1987 by some $12.3 billion.

We did release detailed general explanations of these provisions last Friday, February 17. For the most part, these provisions relate to technical deficiencies in the operation of various provisions of the Internal Revenue Code. These deficiencies have permitted taxpayers to claim unintended tax benefits, and in some cases abusive tax shelter transactions and offerings have grown up around these provisions that have been widely publicized and marketed. We are hopeful that the committee will act rapidly in dealing with these areas.

There are three basic areas in our proposals in what we call the accounting and time value of money issues, several proposals dealing with corporate and securities transactions, and then proposals dealing with partnerships, and some miscellaneous proposals. I am going to spend the most time this morning on the first one, the time value of money, and then I will mention briefly the partnership proposals.

The time value of money issues arise because the Internal Revenue Code does not taken into account the effect of high interest rates and inflation on the value of money. In the simplest terms, the time value of money is the difference between the value of funds immediately available and the right to receive funds at some time in the future. But the code tends to ignore this difference.

For example, an accrual basis taxpayer may be able to claim a $1 deduction currently even though the $1 will not be paid for a long period of time, several years in many instances. Obviously a $1 expense payable 10 years from today is a much less costly expense than a $1 expense payable today.

The failure of the code to recognize the difference in the magnitude of the expense resulting from the difference in time for payment has permitted taxpayers to obtain substantial and, we think, unwarranted tax benefits, and has led to numerous tax shelter transactions resulting in significant revenue loss to the Treasury.

Even though interest rates have fallen and it looks as though the inflationary spiral of recent years has been broken, we think this is an important problem, and it is now time for a fundamental reexamination of several provisions of the code that do not properly take into account the time value of money.

The first aspect of this problem I will mention is the overstatement of deductions for future expenses. In several recent cases, the courts have applied the all events test to permit accrual basis taxpayers to deduct currently expenses that will not be paid for several years in the future.

The potential revenue loss from this overstatement of deductions is quite large. Our proposal would curb overstated premature accruals by not permitting the accrual of the expense prior to the time that economic performance in respect of the expense has occurred.

An example of the problem and the potential revenue loss that arises from it can be seen quite easily. Let us assume that an accrual basis taxpayer becomes obligated in 1984 to render a service in 1991, and assume that he can estimate with reasonable accuracy in 1984 the cost of the rendering of the service in 1991, and the cost would be $1 million.

If we pick an 8-percent-after-tax discount rate between 1984 and 1989, the 1991 expense had a present discounted value in 1984 of $583,000. That is the discounted value of the $1 million expense payable in 1991.

Recent court decisions would allow the full $1 million deduction in 1984, thus clearly overstating the true economic cost of the future expense by some $416,000. This misinterpretation of the value of the deduction has become the cornerstone of a variety of tax shelters. For example, a shelter partnership may obligate itself to pay research and experimentation expenditures in the future and claim a deduction for the undiscounted amount of the cost currently.

In addition, the failure to discount future deductions payable far in the future has significant ramifications outside of the tax shelter area. Taxpayers as a part of everyday business operations incur a number of obligations to pay expenses in the future.

For example, employment-related accidents may involve workmen's compensation claims payable in the future. Other accidents may give rise to tort liabilities. The strip mining of land will often necessitate future reclamation costs. The operation of a nuclear powerplant will necessitate the eventual decommissioning of the plant. Offshore oil drilling will necessitate the eventual removal of the offshore drilling platform.

To the extent the taxpayers have been able to argue successfully that such future expenses are fixed and determinable with reasonable accuracy in the current taxable year and thus technically comply with the all events test of the law, they have contended that they can deduct currently the undiscounted amount of the expense without regard to when it is going to be paid.

So we are proposing that the all events test be amended to provide that no deduction be allowed prior to the time economic performance in respect of the particular liability occurs.

Economic performance would be defined to occur in the case of an obligation to pay research and experimentation costs when the research is performed; in the case of the workmen's compensation claim or structured settlement of tort liabilities, when payment is made extinguishing the liability of the claimant; in strip mining cases, when the land is reclaimed; in nuclear plant or offshore drilling cases when the facility is decommissioned or dismantled.

Mr. Chairman, this is the basic rule that is applied in accounting for such future payments, and we think it is the correct rule. We would propose that to be certain that the future deduction is available to reduce tax liability when the economic performance occurs, that you extend the net operating loss carryback provisions in these types of cases, and we have some specific rules in that regard.

The second time value question involves deferred payments. The rules applicable to deferred payments under the Internal Revenue Code are flawed in a number of respects. Section 483 of the code is not effective in preventing taxpayers from artificially understating the interest component. Second, the imputed interest provisions of 483 create deemed payments of interest without regard to the rate at which interest accrues economically so that deductions may be artificially accelerated and tax liabilities understated.

And third, the original issue discount rules in section 1232A and 163(e) governing the time for inclusion and deduction of an original issue discount are generally inapplicable to the borrowing that occurs in many deferred payment transactions, thus permitting substantial mismatching of the deductions and income.

Dealing first with the 483 problems, current law is that a simple interest test rate is provided to see if sufficient interest is stated by the parties. Under current rules, if the parties state 9 percent simple interest with respect to deferred payments, the allocation between the principal and interest elements of the transaction will be respected for income tax purposes.

The simple interest rate does not reflect a proper economic computation of interest, because interest that is earned but not paid does not itself bear interest in a simple interest computation. As a result, the use of a simple interest formulation allows taxpayers to understate, sometimes dramatically, the interest element of a transaction.

For example, an obligation that bears 9 percent simple interest for 30 years is actually bearing 4.5 percent per year interest in a proper economic computation. When the interest component of a deferred payment transaction is understated, the tax basis of the acquired asset is overstated and excessive depreciation and investment tax credits may be claimed.

We have seen a number of transactions which exploit this flaw. In one case, a tax basis of more than five times the established fair market value of the property was claimed. The excess basis represents interest in economic terms and should be deductible only as it accrues over the life of the obligation, but if you look strictly to the section 483 test rate, that excess is transformed into inflated ITC and ACRS allowances having a materially higher present value than the future interest deductions.

Turning to the actual operation of section 483, the 483 rules now state that if adequate interest is not stated by the parties to the contract, it says that interest is deemed to be paid with each payment, and that has given rise to what we refer to as the two payment abuse.

For example, one payment might be due 6 months after the date the contract is signed. A second equal payment due 30 years after the contract is signed. A strict reading of the 483 rules allocates one-half of the imputed interest to the payment due in 6 months, while, of course, in fact the great preponderance of the interest is attributable to the deferred payment due 30 years hence.

But by allowing a large portion of the interest to be attributable to the payment due in 6 months, the effect is to allow the purchaser to claim current deductions for fully one-half of the cost of a nondepreciable asset.

We think this two-payment transaction is a serious abuse of the tax system, and we are requesting that this be curbed effective as of the date of committee action.

The third problem in this area is the mismatching of income and deductions in the case of discount interest in deferred payment transactions. A common feature of many tax shelter arrangements involving the purchase of real estate or machinery on a deferred basis is a provision in the obligation that states interest will accrue each year but will not be paid until maturity.

The issuer of the obligation using the accrual method will claim annual deductions of the interest accruing over the life of the obligation, whereas the seller—the holder of the obligation—being a cash basis taxpayer, will simply fail to report any interest income until the obligation matures.

If you assume that property is purchased for $20 million with interest accruing at a rate of 12.5 percent, but that the payment of the interest is deferred for 20 years, the present value of the tax reduction attributable to the aggregate deductions claimed by a purchaser in the 50-percent marginal bracket, and therefore the revenue loss to the Government is $22.2 million.

The present value to the Government of the income inclusion of the cash method of seller at the end of the contract, if you assume he is also in the 50-percent bracket, the value is $9.1 million, so you have a mismatching and a cost to the Government of some $13.1 million in a $20 million transaction.

To deal with these deficiencies in the treatment of the original issue discount in deferred payment transactions, we are proposing several changes. First, we are proposing that the 483 rules for measuring interest in deferred payment transactions be based on a compound interest test rate. In addition, independent interest rates under section 483 would be fixed for short-, medium-, and long-term obligations, so that the 483 rate would approximate more closely a market rate of interest.

The rate would also be adjusted automatically at 6-month intervals to provide a more current and accurate interest rate than can be achieved by periodic amendment to the regulations, but the rate governing a particular transaction would be the rate in effect at the date the contract is entered into, and it would not thereafter fluctuate. The same rate structure would be used in determining the applicable rate under 482 with respect to commonly controlled businesses.

Also, the scope of the original issue discount rules of 1232A and 163(e) would be broadened to include all purchases of property for discount obligations, but we would have exceptions for a number of transactions—sales of farms by individuals or by small businesses of $1 million or less, sales of principal residences, sales of services, or the right to the use of property, where payment is not deferred for a period of more than a year, and any sale involving payments of less than $250,000.

This expansion of the OID rules would prevent the mismatching of interest income and deductions in deferred payment transactions involving discount payments, but because these rules apply only to cases involving deferred payments in which adequate interest is not stated or interest is not payable at least annually, the bulk of the deferred payment transactions would not be affected by the proposals.

In addition, the exceptions that I have listed will limit the applicability of the original issue discount rules to transactions that are likely to involve abusive tax-shelter techniques that create substantial unintended benefits.

The proposals generally would not burden cases in which an individual might sell his own family farm for an obligation that does not provide for current interest payments.

We also have a proposal, Mr. Chairman, dealing with prepayment of expenses by allowing cash basis taxpayers to deduct prepayments of expenses. Taxpayers claim the right to manipulate their taxable income from year to year, and of course tax shelter partnerships often use this device. If investors invest in tax-shelter partnerships year after year, there can, in effect, be an indefinite deferral of tax liability.

We are simply proposing that section 461 be amended to prevent tax shelters from deducting prepaid expenses prior to the period to which the expense is properly allocable. This proposal would apply only to tax shelter transactions. Payment of expenses outside the context of tax shelters would be unaffected.

And then we are also proposing that market discount on bonds be treated like original issue discount. Under current law, market discount is given capital gain treatment where, in fact, market discount is in all respects the equivalent of interest income to the bondholder. It exists in lieu of a coupon interest rate, and is reflected in the fixed and predictable growth in the value of the bond from the date the purchaser buys it in the secondary market, it is indistinguishable from original issue discount.

So, we are proposing that market discount be treated as interest income to the holder of the bond. We are not, however, proposing that the income be accrued over the life of the obligation, because that does involve a lot of complexity, even though theoretically correct. We are simply saying that on a disposition of the bond, the market discount be treated as ordinary income rather than capital gain. Gain in excess of the market discount would continue to be treated as capital gain.

And finally, in the time value of money context, let me mention the area of interest-free loans. Interest-free loans between family members, and between corporations and their shareholders and employees have been used as a tax planning device with increasing frequency in recent years.

The courts generally have rejected the arguments of the Internal Revenue Service that these are in effect devices to shift income or to provide compensation. The Supreme Court does have under review the question of whether interest-free demand loans to family members constitute gifts.

In contrast to the intrafamily loans and loans between businesses and their owners and employees, the law has been clear for a number of years that low interest and interest-free loans between commonly controlled organizations are subject to an interest imputation rule under section 482.

So we are proposing, Mr. Chairman, that interest-free loans between family members and between a business and its owners and employees be treated as its economic equivalent, that is, that the loan be treated as if interest were actually charged and paid at a specified rate, and the lender had rebated the interest to the borrower.

Care has been taken to prevent these new rules from applying to the common family loan situation not involving tax avoidance. In general, loans to family members of $10,000 or less per borrower are exempt from the proposal. Family loans cumulating less than $100,000 per borrower will produce no tax consequences to the lender, except to the extent that his passive income exceeds $1,000, thus evidencing the loan was used to shift passive income from the lender to the borrower rather than for personal consumption, such as education or the purchase of a home.

These exceptions would not apply if the loan were used to purchase or carry passive income-producing assets.

Mr. Chairman, we have a number of proposals dealing with corporate and securities transactions. They are rather detailed. I think I will skip over those and go directly to the partnership provisions.

I will mention only three of the partnership provisions that we see as responding to particularly troublesome situations. The first involves the use of special allocation rules in attempts to avoid capitalization of partnership costs.

For example, a tax shelter partnership makes an allocation of gross or net income and distributes cash representing the allocation to a person who performs services for the partnership.

This arrangement is often used in lieu of a syndication fee that would clearly have to be capitalized. We are proposing that any partnership allocation that has the effect of creating the equivalent of immediate deduction with respect to an item normally required to be capitalized should be disregarded.

We are not proposing, however, elimination of item allocations by partnerships.

Second, an equally disturbing device involves the contribution of property to a partnership followed shortly by a cash distribution from the partnership to the partners. In effect, this transaction is often in substance a disguised purchase and sale between the partners of a partial interest in the property or a part contribution and part sale between the partner and the partnership.

The Internal Revenue Service has argued that the transaction should be taxed in accordance with its substance, but the courts have generally respected the form the partners use in carrying out the transactions, and thus give the contributing partner the benefit of recovering his full basis in the contributed property before reporting any gain on the distribution.

We are simply proposing that the Code be amended in the contribution distribution arrangement to treat the transaction in accordance with its economic substance, irrespective of the form of the transaction.

Finally, in the partnership area, partnership rules relating to contributions of property give rise to numerous income and loss assignment possibilities. These are transactions designed to permit a partner contributing property with unrealized gain or loss to shift the built-in gain or loss to other partners. Other transactions involve contributions of property designed to convert built-in ordinary income into capital gain or built-in capital loss into ordinary loss.

We are proposing that depreciation, depletion, and gain or loss on property contributed to a partnership be allocated so as to take into account the difference at the time of the contribution between fair market value of the property and its basis.

Essentially this would make mandatory the optional rule currently contained in section 704(c)(2). In addition, under the proposal, built-in losses on contributed capital assets would retain their character as capital losses in the hands of a partnership for 5 years from the date of the contribution, and property that is inventory in the hands of the contributing partner would retain its character as inventory in the hands of the partnership for some 5 years.

Then I will mention only one more of our proposals, Mr. Chairman, that dealing with like kind exchanges. We are proposing limits on the like kind exchange rules in two areas—the partnership interest exchanges and the deferred like kind exchanges permitted under the *Starker* case, a Ninth Circuit Court of Appeals case.

With respect to exchanges of partnership interest, we think it is open to question whether like kind exchange rules were ever intended to apply to partnership interests. They do not apply to exchanges of stock certificates of trusts or other securities or evidences of interest, and partnership interests can properly be viewed as very similar to these excluded items.

It is also unclear how the underlying assets of the partnership should be tested to see if indeed a like kind exchange has occurred. Significant revenue is involved in partnership exchanges, for one reason because attempts are made to use these rules to avoid recognition of gain in disposing of burned-out tax shelters. We are simply proposing that the nonrecognition provisions not be applicable to any exchanges of partnership interests.

Finally, with respect to deferred like kind exchanges, we think the transactions have simply gotten out of hand. The policy basis for deferring recognition ceases to exist when property transferred is given a specific dollar value and the seller can designate property of that value he is to receive in months or years in the future.

The gain may be accurately measured, and the rights the seller receives are very close to the right to receive cash on demand.

Also, these transactions can raise significant administrative problems, particularly when pushed to the extreme, so we are proposing that property received more than 90 days after the taxpayer transfers property relinquished in an attempted like kind exchange would simply not qualify as a like kind exchange.

Mr. Chairman, I think that summarizes the more significant of the proposals in our package. I think I will end it there. I would be happy to respond to any questions on these or other proposals in the administration's package.

[The prepared statement follows:]

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY (TAX POLICY), DEPARTMENT OF THE TREASURY

Mr. Chairman and members of the committee, I am pleased to have the opportunity to describe the Administration's proposals in the area of tax shelters, accounting abuses, and certain corporate and securities transactions. These proposals are contained in the Administration's budget for fiscal year 1985 and, if enacted, will increase revenues by $12.3 billion during the 3-year period of fiscal years 1985-1987. Detailed summaries of the proposals are contained in General Explanations issued by the Treasury Department on February 17, 1984.

For the most part the proposals relate to technical deficiencies in the operation of various provisions of the Internal Revenue Code. These deficiencies have permitted taxpayers to claim unintended tax benefits, and in some cases have led to abusive tax shelter tranactions that have been highly publicized and widely marketed. We are therefore hopeful that this Committee will act promptly on these proposals.

I. ACCOUNTING AND TIME VALUE OF MONEY ISSUES

The high interest and inflation rates that we have experienced in recent years bring into question economic assumptions that underlie certain provisions of the International Revenue Code. These high rates have resulted in a material increase in the "time value of money." In the simplest terms, the time value of money is the difference between the value of immediately available funds and the right to receive funds at some time in the future. In many respects, the Internal Revenue Code ignores time value of money concepts. For example, the Code in some cases may permit an accrual basis taxpayer to claim a $1 deduction currently even if the $1 will not be paid for a long period of time—as much as ten years or longer. Obviously, a $1 expense paid today is much more costly than a $1 expense payable 10 years from now, but the Code in some instances treats the two cases as if they were identical—granting a current $1 deduction in both cases. The failure of the Code to recognize the difference in the magnitude of the expenses as a result of the differing time for payment has permitted taxpayers to obtain substanital unwarranted tax benefits and led to numerous abusive tax shelter transactions—resulting in a substantial revenue loss to the government. Even though interest rates have fallen and the inflationary spiral of recent years has been broken, we believe the time has come for a fundamental reexamination of several provisions of the Code that do not properly take into account time value of money concepts.

I will focus here on five areas of concern: (i) the overstatement of deductions by accrual method taxpayers who in certain cases can deduct currently expenses that will not be paid for many years; (ii) the opportunity of taxpayers to understate the interest component and overstate the principal component in deferred payment transactions and the mismatching of interest income and deductions in such transactions; (iii) the ability of taxpayers to district income by prepaying deductible expenses; (iv) the failure of the Code to treat market discount on bonds as interest income; and (v) the failure of the tax law to analyze correctly interest-free and low-interest loans.

(1) Overstatement of deductions for future expenses

Recent court decisions in some cases have permitted accrual method taxpayers to deduct currently expenses that will not be paid until far into the future. As noted above, allowing taxpayers to take deductions today for tomorrow's expenses overstates the true cost of the expenses to the extent the time value of money is not taken into account. The potential revenue loss from these overstated deductions is enormous. The Administration's proposal will curb overstated, premature accruals by not permitting accrual of expenses prior to the time that the economic performance in respect of the expenses occurs.

The time value of money principle takes account of the fact that a liability to incur future expenses in an amount of $10 has a present dicounted value of less than $10. From an economic point of view, a taxpayer's future expenses should be valued at $10 if deducted when the liability is satisfied, or at the discounted present value of less than $10 if deducted prior to the time the liability is satisfied.

An example illustrates the magnitude of the revenue loss that may be associated with an overstatement of prematurely accrued liabilities. Assume that an accrual method taxpayer becomes obligated in 1984 to render a service in 1991, and that the taxpayer can estimate with accuracy in 1984 that the cost of rendering the service in 1991 will be $1,000,000. If we assume an 8 percent after-tax discount rate between 1984 and 1991, the taxpayer's 1991 expense has a present discounted value in 1984 of approximately $583,500. Recent court interpretations of the "all events" test of current law might permit the taxpayer in the above example to deduct $1,000,000 in 1984. This premature accrual overstates the true economic cost of the future expense by $416,500.

In the above example, the failure of current law either to limit the taxpayer's current deduction to its present discounted value of $583,500, or to require that the full $1,000,000 be deducted only when the liability is satisfied in 1991, had become the cornerstone for a variety of tax shelters. For instance, a tax shelter partnership may obligate itself to pay research and experimental expenditures in the future and claim a current deduction for the undiscounted amount of the costs to be incurred. (I should note that we do not believe that incurring an obligation to pay for services to be performed in the future gives rise to a proper accrual under the "all events" test.)

The failure of current law to discount deductions payable far in the future also has significant ramifications outside the tax shelter area. Taxpayers incur as part of everyday business operations a myriad of obligations to pay expenses in the future. For instance, an employment-related accident may involve a worker's compensation claim; other accidents may give rise to tort liabilities; the strip mining of a tract of land will often necessitate future reclamation costs; the operation of a nuclear power plant will necessitate the eventual decommissioning of the plant; offshore oil drilling will necessitate the eventual removal of the offshore drilling platform. Similarly, some employers incur liabilities to make periodic contributions to voluntary employees' beneficiary associations; others incur liabilities to make future payments to employees and their dependents if the employees are terminated upon the closing of a plant. To the extent taxpayers have been able to argue successfully that such future expenses are fixed and determinable with reasonable accuracy in the current taxable year, they have contended that they can deduct currently the undiscounted amount of these expenses, without regard to when the expenses will be paid.

To deal with the severe problem posed by overstated "premature" accruals of future expenses, we are proposing that the "all events" test be amended to provide that no deduction will be allowed prior to the time economic performance in respect of a particular liability occurs. Economic performance will be defined to occur in the case of an obligation to pay research and experimentation costs when the research is performed. Economic performance in respect of worker's compensation claims or structured settlements of tort liabilities will occur when payments are made extinguishing liability to claimants; in strip mining cases when the land is reclaimed; in nuclear power plant or offshore drilling cases when the facility is decommissioned or dismantled.

We recognize that by requiring deductions for future expenses to be taken in the year of economic performance, it is also necessary to amend the net operating loss carryback rules. Our proposal would extend the carryback period in appropriate circumstances to ensure that deferred expenses may be utilized fully. Generally, expenses attributable to liabilities arising more than 3 years prior to economic performance will be permitted to be carried back for a period not to exceed 10 years, subject to transition rules. Special carryback rules might be appropriate for certain expenses such as nuclear power plant decommissioning costs.

The premature accrual rule would not apply to transactions that have specific statutory rules governing the timing of deductions, such as transfers to which section 83 applies; bad debt deductions provided under section 166; any transaction to which section 267 applies; employer contributions or compensation to which section 404 applies; or an accrual to which section 463 or 466 applies (relating to vacation pay and qualified discount coupons).

We recognize that generally accepted accounting principles frequently require the establishment for financial accounting purposes of current reserves for future expenses, thus reducing net profit as reported on financial statements. However, reserve accounting is not an appropriate means of reflecting future expenses for federal income tax purposes. Experience with Code section 462, which was enacted in 1954 and repealed less than 12 months later, illustrates that for federal income tax purposes, reserve accounting presents insurmountable administrative and compliance problems.

Our proposal has been criticized for failing to match properly the future expense with the current income that gives rise to that expense. Those who express this criticism argue that future expenses should be deductible at discounted values over the period of economic activity giving rise to the expenses. While allowing a current deduction for the present discounted values of future expenses clearly is proper from the perspective of creditors and others who utilize financial statements, various practical considerations preclude implementing such a rule for income tax purposes.

As an administrative matter, determining the present discounted values for all kinds of future expenses would introduce unmanageable uncertainty and undesirable complexity. Discount rates could not be determined individually for each business. Rather, certain economy-wide average discount rates would have to be employed. These discount rates would have to be applied to mere estimates of the amount of the expenses to be incurred at estimated dates in the future. Any discounted expenses therefore would represent only an estimate of future expenses, and that estimate would be wrong in every case in which either the amount of the future expenses or the time for economic performance was estimated incorrectly. A system that allowed current deductions for discounted future expenses would have to include a complex set of recomputation rules for recalculating overstated and understated deductions when the future liabilities were actually satisfied at a time or in an amount different from that originally projected.

Thus, to prevent deductions being taken for future expenses in excess of their true cost, while avoiding the arbitrariness and complexity of a system of present discounted valuation, we propose that expenses be accrued only when economic performance occurs.

(2) Deferred payments

The current tax rules governing transactions that involve deferred payments are seriously flawed in several respects. First, section 483 of the Code in many cases is not effective in preventing parties to a deferred payment transactions from artificially understating the interest component of the transactions. Second, the imputed interest provisions of section 483 create deemed payments of interest without regard to the rate at which interest accrues economically, so that interest deductions may be artificially accelerated and tax liabilities understated. Third, the rules of sections 1232A and 163(e) governing the time for inclusion (and deduction) of original issue discount are generally inapplicable to the borrowing that occurs in deferred payment transactions; the failure to apply the original issue discount rules to these transactions has permitted substantial mismatching of interest deductions and inclusions resulting in substantial revenue losses to the government. I will discuss each of these problems in greater detail, and then review our proposals to deal with these problems.

Currently, a simple interest test rate is provided under section 483. Thus, if the parties to a deferred payment transaction state at least 9 percent simple interest with respect to the deferred payments, the allocation between the principal and interest elements of the transaction generally will be respected for income tax purposes. The simple interest test rate under section 483 does not reflect a proper economic computation of interest because interest that is earned but not paid does not itself bear interest in a simple interest computation. In economic terms, unpaid interest itself gives rise to a further interest charge because any forbearance of the payment of cash—whether denominated interest or principal—requires compensation to the lender. As a result, the use of a simple interest formulation in the context of deferred payments allows taxpayers to understate, sometimes dramatically, the interest element of the transaction. For example, an obligation that nominally bears simple interest of 9 percent per year payable at the end of 30 years in fact bears interest of 4½ percent per year using a proper economic computation. The foregoing analysis assumed that the purchaser's obligation represents a bona fide indebtedness. If, for example, a nonrecourse obligation were given in an amount that exceeded the value of the property securing the debt, all or a portion of the alleged debt would be disregarded.

Where the interest component of a deferred payment transaction is understated, the tax basis of the acquired asset is concomitantly overstated, with the result that excess investment tax credits ("ITC") and depreciation allowances under the accelerated cost recovery system ("ACRS") may be claimed. We have seen a substantial number of recent transactions that exploit this flaw in the operation of section 483. In some cases a tax basis of more than five times the established fair market value of the property is claimed. The excess basis represents interest in economic terms and should be deducted only as it accrues over the life of the obligation. However, by virtue of the defective operation of the section 483 test rate, that excess is transformed into inflated ITC and ACRS allowances having a materially higher present value than the interest deductions (although the understatement of the interest element of the transaction may be subject to challenge by the Internal Revenue Service).

Turning to the operation of the section 483 rules, if the parties to a deferred payment transaction fail to state interest adquate to meet the section 483 test rate, the section 483 rules allocate the imputed interest among the deferred payments solely in proportion to the relative size of the payments, not taking into account the time of payment. Some taxpayers have relied upon this allocation rule to structure highly abusive transactions that accelerate multiple years' interest charges into the year the transaction occurs. Frequently, these transactions involve the purchase of nondepreciable property, such as corporate stock. The transactions typically provide for one payment at the end of six months, and a second payment (in approximately the same amount) due far in the future—such as at the end of 30 years. The payments bear no stated interest. (Because the payment due at the end of 30 years has very little present economic cost or value, the bulk of the purchase price is reflected in the payment due in six months.) Section 483 imputes interest in the transaction in an amount equal to roughly one-half of the total payments. It then allocates one-half of the imputed interest to the payment due in six months. In effect, the interest allocation rules of section 483 function to allow taxpayers to claim current deductions for fully one-half of the cost of a nondepreciable asset. Moreover, by acting at the proper time to dispose of the purchaser's obligation due at the end of six months, the seller of the property may be able to avoid having one-half of the payment treated as interest. We think these "two payment transactions" constitute a serious abuse of the tax system. We therefore request that this Committee act to curb these transactions effective as of the date of Committee action.

The third problem I wish to discuss in this area is the mismatching of deductions and income in the case of discount interest in deferred payment transactions. A common feature of many tax shelter arrangements involving the purchase of real estate or machinery and equipment on a deferred payment basis is a provision in the obligation that stated interest will "accrue" each year but not be paid until maturity. The issuer of the obligation (the purchaser), who uses the accrual method of accounting, will claim annual deductions for the accruing interest, while a cash method holder (the seller) defers the interest income inclusion until maturity of the obligation. The revenue loss to the government from these transactions is substantial. Assume, for example, that property is purchased under a $20,000,000 purchase money mortgage with interest accruing at the rate of 12.5 percent, but payment of the interest is deferred for a period of 20 years at which time the instrument matures. The present value of the tax reduction attributable to the aggregate deductions to be claimed by the purchaser-borrower in a 50 percent marginal tax bracket—and, therefore, the revenue loss to the government—is $22.2 million. On the other hand, the present value to the government of the income inclusion to a cash method seller-lender also in the 50 percent tax bracket is $9.1 million. Thus, the mismatching in this transaction has a cost to the government of $13.1 million. We believe that the overall revenue loss from this "deferred interest" structure is increasing dramatically as these transactions proliferate.

In cases where the original issue discount rules of sections 1232A and 163(e) apply both parties to a deferred payment transaction are required to account for the annual accruals of "deferred interest" under the accrual method of accounting, irrespective of the method of accounting they otherwise employ. In general, borrowers and lenders have been required to employ the accrual method of accounting for original issue discount lending transactions since 1969. The effect of these rules is to place discount interest on the same footing as stated interest that is paid each year by recognizing that, in substance, a discount borrowing involves a current payment of interest to the lender, and the lender's re-loaning that interest to the borrower. At present, however, the original issue discount rules are not applicable to obligations issued in exchange for property (unless the property sold is stock or securities that are publicly traded, or the obligation issued is publicly traded). Thus, the opportunity to avoid taxes through a mismatching of interest income and deductions derives from the failure of the current Code provisions to treat the lending that is implicit in a deferred payment transaction in a manner comparable to a pure lending transaction.

In addition to the asymmetrical treatment of issuers and holders, discount obligations issued in tax shelter transactions of the type described above frequently embody a noneconomic computation of interest, such as straight-line interest or simple interest payable on a deferred basis. Both computations accelerate interest deductions by improperly identifying the period to which the interest charge is allocable. Cash method holders of the obligations are, of course, indifferent to these timing concerns because they defer inclusion until maturity. Although the use of noneconomic interest calculations is largely proscribed by Revenue Ruling 83-84, 1983-1 C.B. 97, several recent tax shelter offerings have taken positions inconsistent with that ruling.

Finally, the original issue discount rules of sections 1232A and 163(e) are inapplicable to obligations issued by natural persons. This fact has afforded taxpayers the opportunity to circumvent the accrual/matching rules applicable to original issue discount borrowings. The complexity of these rules mandates that these rules not be applied to routine transactions entered into by individuals, however.

To deal with these deficiencies in the tax treatment of original issue discount in deferred payment transactions, the Administration is proposing the following changes in the law:

The operation of the section 483 rules for measuring interest in deferred payment transactions would be improved by use of a compound interest test rate. In addition, independent interest rates under section 483 would be fixed for short-, medium- and long-term obligations, so that the section 483 rates approximate more closely a market rate of interest for each category of obligation. These rates would be adjusted automatically at six-month intervals to provide a more current and accurate interest rate than can be achieved by periodic amendment to the regulations. (The rate in effect at the date the contract is entered into would govern the contract; the rate would not thereafter fluctuate.) Interest that is imputed under section 483 would be taken into account by the parties under the accrual accounting rules of sections 1232A and 163(e), using a constant interest (or yield-to-maturity) computation that conforms to the economic accrual of interest. An interest rate structure that parallels the new section 483 rules also would be provided to determine the safe-harbor interest rate for loans between commonly controlled businesses that are subject to section 482.

The scope of the original issue discount rules of sections 1232A and 163(e) would be broadened to include all purchases of property for discount obligations. Transactions of the following types would not be brought within the expanded original issue discount rules: (i) sales of farms by individuals or by small businesses for $1 million or less; (ii) sales of principal residences by individuals; (iii) sales of services or the right to the use of property where payment is not deferred for a period of more than one year after the liabilities is properly accruable (provided that deferred payments for services subject to section 83 or 404 in all events would be excepted from the expanded original issue discount rules); and (iv) sales involving total payments of $250,000 or less. The original issue discount rules would be made applicable to obligations issued by individuals.

This expansion of the original issue discount rules will prevent the mismatching of interest income and deductions in deferred payment transactions involving discount obligations. Because these rules apply only to cases involving deferred payments in which interest is not stated or interest is not payable at least annually, the bulk of deferred payment transactions will not be affected by the proposals. In addition, the exceptions provided will limit the applicability of the original issue discount rules to transactions that are likely to involve abusive tax shelter techniques or the creation of substantial unintended tax benefits. These proposals generally will not burden cases in which an individual might sell his home or family farm for an obligation that does not provide for current interest payments. We also have proposed certain other related changes to the original issue discount rules and section 483.

In general, we have proposed that these changes be effective for transactions entered into after December 31, 1984. An earlier effective date is needed, however, to curtail the "two payment transaction" described above. Although such transactions may be vulnerable to attack under present law, we request that this Committee act at the earliest possible time to make clear that the restrictions on the deductibility of prepaid interest prevent the acceleration of large interest deductions in these transactions.

(3) Prepayment of expenses

Current law provides that a taxpayer using the cash method of accounting may deduct an expense in the year it is paid. However, current law also provides that any expenditure that results in the creation of an asset having a useful life extending substantially beyond the close of the taxable year may be deductible only in part, or not at all, in the taxable year in which paid. In general, courts have examined prepayments of expenses by determining whether the allowance of a full deduction in the year of payment results in a material distortion of income. Certain court decisions have been interpreted as establishing a "one year rule" under which some prepayments of expenses may be deducted if they do not provide benefits that extend beyond one year.

We are concerned that to the extent current law permits cash method taxpayers to deduct prepayments of expenses, taxpayers are able to manipulate their taxable income from year to year. Tax shelter partnerships often prepay deductible expenses in an attempt to maximize deductions for investors. Since income from the tax shelter activities is generally not generated until tax periods occurring after the prepayments, the prepayments are used to offset other taxable income of the investors. If investors in tax shelters are able to deduct prepayments of expenses year after year, they are able to manipulate their taxable incomes indefinitely.

For example, investors may contribute to a tax shelter which uses the contributions to prepay expenses of $1 million in December 1984. These expenses may be allocable to income-generating activities carried out in years 1985 through 1987. Under current law, the investors may be able to deduct the prepaid expenses in 1984. In years 1985 through 1987, if the tax shelter begins to generate income, the investors may again prepay expenses, either in the original shelter or in new shelters. By continually prepaying expenses, investors succeed in deferring indefinitely the tax on their sheltered 1984 income.

The distortion of income inherent in allowing the prepayment of expenses arises because the expenses are not properly allocable to the periods in which the expenses generate income. Congress previously recognized the potential for such distortion with respect to the prepayment of interest. Section 461(g) precludes deductions for prepaid interest. Thus, interest is deductible in the periods for which it represents a charge for the use of borrowed money.

The Administration's proposal would further amend section 461 to prevent tax shelters from deducting prepaid expenses prior to the period to which such expenses are properly allocable. Although the prepayment issue is frequently perceived as a problem with respect to the cash method only, accrual method taxpayers may sometimes take the position that they are entitled to deduct prepayments. Our proposal will require that both cash and accrual taxpayers deduct prepayments as economic performance occurs, i.e. when the economic activities for which the prepayments were made actually occur, such as the provision of goods or services.

The Administration's proposal will apply only to tax shelter transactions. Prepayments of expenses outside the context of tax shelters would continue to be governed by current law. The proposal will not affect the rules that govern the time at which prepayments are included in the income of the recipient.

(4) Market discount on bonds

Current law distinguishes between the treatment of market discount and orginal issue discount on bonds. Original issue discount arises when a bond is issued for an amount less than the redemption price of the bond, the spread or discount representing additional interest compensation to the holder of the bond. Original issue discount is required to be included in income by the holder over the life of the bond, irrespective of the bondholder's method of accounting.

Market discount arises where a bond decreases in value subsequent to the time of issuance, typically because of an increase in interest rates, and is then purchased in the secondary market. The market discount equals the spread between the purchase price of the bond in the secondary market and the amount to be paid on maturity of the bond. Under current law, market discount is not taxed until the sale or maturity of the obligation, and is taxed as capital gain income if the obligation is issued by a corporation or governmental entity. (On retirement of obligations issued by persons other than corporations and governmental entities, market discount is taxed as ordinary income, rather than as capital gain.)

Where a bond is acquired at a premium, the holder is permitted under present law to amortize the bond premium over the remaining life of the bond. (Market bond premium arises when bond prices increase, typically due to a decrease in interest rates.) Thus, current law enables the taxpayer to claim a deduction against ordinary income for an allocable portion of the bond premium instead of claiming a capital loss on the maturity (or sale) of the obligation.

Market discount is in all respects the equivalent of interest income to the holder of a bond; it exists in lieu of coupon interest, and is reflected in the fixed and predictable growth in value of the bond according to a compound interest formula. From the viewpoint of the bondholder, market discount is economically indistinguishable from original issue discount.

The current tax treatment of market discount offers opportunities for deferral of taxes on ordinary income and for conversion of ordinary income to capital gain. Because the market discount element of the interest return on a bond accrues currently as an economic matter but is not taxable until maturity (or sale of the obligation), and then only at capital gains rates, tax shelter transactions have arisen in which taxpayers acquire market discount bonds using borrowed funds. The cost of carrying the market discount bond is deducted currently against ordinary income from investments and the like, while the reciprocal return on the bond—accretion of market discount—is taxed at capital gain rates when the obligation matures. Thus, ordinary income is both deferred and converted to capital gain.

The Administration is proposing that market discount be treated as interest income to the holder of the bond. This treatment would correspond to the existing treatment of bond premium.

In theory, the accretion of market discount should be included in the income of the bondholder over the life of the obligation on the constant interest method. Our proposal, however, adopts an approach that would be more easily administered and complied with by taxpayers. Gain on sale or retirement of a market discount bond would be characterized as ordinary interest income to the extent of the accrued market discount. Gain in excess of accrued market discount would continue to be treated as capital gain (except on retirement of obligations not issued by a corporation or governmental entity.) The treatment of losses on sale or retirement would be unchanged. The computation of the accrual market discount would be made on a straight line basis, or the constant interest (yield-to-maturity) method, at the election of the taxpayer.

The proposal would not apply to obligations the interest on which is tax-exempt. The market discount on these obligations would continue to be taxed as capital gain on sale or maturity.

The proposal would apply to bonds issued subsequent to the date of enactment of the proposal.

(5) Interest-free loans

Interest-free loans between family members and between corporations and their shareholders have been used as a tax planning device with increasing frequency in recent years. In addition, interest-free or low-interest loans have been used as a means of providing compensation to persons performing services or in other business related situations. Although the Internal Revenue Service has asserted that the value of an interest-free demand loan should be treated as a taxable dividend to a shareholder or taxable compenstion to a person performing services, the courts generally have rejected these arguments. Moreover, under existing law, a person who lends money on an interest-free basis may not be taxable on the income earned with the borrowed funds, even if the loan is payable on demand or in a short period of time. The Supreme Court now has under review the issue of whether interest-free demand loans to family members constitute taxable gifts.

In contrast to intrafamily loans and loans between a business and its owners or employees, an interest-free or low-interest loan betwen two commonly controlled organizations trades or businesses may, under section 482 of the Code, be treated by the Internal Revenue Service as if interest at a specified rate were charged by the lender and paid by the borrower. The rationale of the section 482 approach to interest-free and low-interest loans is that these loans are the economic equivalent of a loan with a market rate of interest paid by the borrower, and a rebate of the interest by the lender in the form of a gift, higher salary, or additional dividends. If interest were charged and rebated, the lender would have interest income, and the borrower generally would have an interest deduction; the rebate of the interest would be classified as a taxable gift, dividend, compensation or otherwise, and would be deductible by the lender, and taxable to the borrower, in accordance with the general rules of the Code. However, such interest-free and low-interest loans now are treated by most courts differently from their economic equivalent. Comprehensive legislation dealing with interest-free and low-interest loans is needed to provide certainty and consistency of treatment as well as to prevent tax avoidance.

One of the primary uses of interest-free loans is to transfer investment income from a high bracket taxpayer to a related taxpayer in a lower tax bracket. In the simplest case, a parent will lend substantial sums to a minor child. Under traditional tax principles relating to grantor trusts, a taxpayer who makes a gift of cash in trust to a child but retains the power to revoke the trust, or makes a gift in a short-term trust the corpus of which will revert in less than 10 years, is taxable on the income earned from the trust's assets.The taxpayer also is deemed to make a taxable gift of the trust income when it is transferred beyond his control. In comparison, if the taxpayer gratuitously transfers the same amount of cash in the form of an interest-free demand or term loan (either of which is analogous to a revocable or short-term trust), the taxpayer may take the position that he is not taxable on the income actually earned, nor on any imputed return deemed to have been earned, from the cash transferred. Moreover, the taxpayer may not be treated as having made a taxable gift of the income earned. Using interest-free loans, a husband and wife in the 50 percent tax bracket who shift $15,000 of investment income to each of their four minor children may reduce the family's income tax liability by approximately $22,000 in every year the loans remain outstanding, without incurring any gift tax liability.

Interest-free loans also have been used where interest deductions, or deductions for compensation sufficient to offset the interest income from an interest-bearing loan, would not have been allowed to the borrower or the lender. Examples include an interest-free loan to an employee that is used by the borrower to purchase tax-exempt bonds (since interest expense incurred to purchase tax-exempt bonds is not deductible), or where the lender makes an interest-free loan instead of paying a dividend or a nondeductible capital expenditure.

To deal with the tax avoidance opportunities presented by interest-free and low-interest loans, the adminsitration is proposing that interest-free or low-interest term or demand loans be treated for income and gift tax purposes as if interest were acutally charged and paid at a specificed rate, and the lender rebated the interest to the borrower. The specified interest rate will be the same as the "arm's length" interest rate prescribed under the section 482 regulations with respect to interest-free loans between commonly controlled trades or businesses.

Care has been taken to prevent these new rules from applying to common family loan situations not involving tax avoidance. In general, loans to family members of $10,000 or less per borrower are exempt from the proposal. Family loans cumulating less than $100,000 per borrower will produce no tax consequences to the lender except to the extent that the borrower's passive investment income exceeds $1,000, evidencing that the loan was used to shift passive income to the borrower rather than for personal consumption purposes such as education or the purchase of a home. These exceptions. however, will not apply if the loan is used to purchase or carry passive income-producing assets.

II. CORPORATE AND SECURITIES TRANSACTIONS

Our proposals dealing with corporate and securities transactions fall into three categories: (i) the tax treatment of corporate dividend distributions in two particular situations; (ii) rules regarding foreign-related transactions; and (iii) rules designed to prevent unintended tax benefits through certain securities transactions. I will discuss two proposals in the first category in some detail—the treatment of dividends on stock investments made by corporations with borrowed funds and the treatment of ordinary, non-liquidating distributions of property.

(1) Leveraged stock investments by corporations

In general, the Code allows corporations (other than S corporations) a deduction equal to 85 percent of dividends received. The purpose of the intercorporate dividends received deduction is to prevent multiple taxation of income as it flows from the corporation that earns the income to the ultimate noncorporate recipient of the income. Thus, the intercorporate dividends received deduction furthers a policy of taxing corporate earnings once to the corporation that earns the income, and a second time when a noncorporate shareholder receives the income in the form of a dividend. In the absence of the dividends received deduction, the shareholder level tax might be collected more than once.

If a corporation borrows funds for the purpose of making an investment in stock of another corporation, interest on the borrowing generally is deductible by the corporation making the investment. Section 265(2) of the Code disallows a deduction for interest on debt incurred or continued to purchase or carry obligations the interest on which is tax-exempt, but this provision does not apply to a corporation carrying an investment in corporate stock, even though dividends paid on the stock are 85 percent tax-exempt.

Recently, tax shelter-type transactions have emerged in which corporate taxpayers incur indebtedness for the purpose of acquiring dividend-producing corporate shares. The availability of the dividends received deduction, coupled with a deduction for the offsetting interest expense, can produce unintended tax benefits. As stated, the dividends received deduction was added to the law to prevent excessive taxation of dividend income as it flows through multiple tiers of corporations. A critical premise of the deduction, however, is that when the recipient corporation distributes the dividend income, it be in the form of a non-deductible dividend. Where the dividend income passes through the intermediate corporation and does not change its character, the intercorporate dividends received deduction mechanism works correctly—both a corporate level tax and a shareholder level tax will be collected on the earnings. If, however, the dividend income is transmuted into tax-deductible interest payments by the intermediate corporation, the premise of the intercorporate dividends received deduction is not satisfied; the change in character of the income translates into avoidance of the corporate level tax on the income. This tax avoidance arises because the intermediate corporation obtains a deduction for the interest paid as well as the dividend received, effectively resulting in a negative tax on the dividend income that offsets the corporate tax paid by the corporation that earned the income.

To curtail this opportunity to avoid tax, the Administration is proposing that in cases in which a corporation incurs debt that would not have been incurred but for an investment in stock, deduction of the interest on the debt would be subject to disallowance. In general, the amount disallowed would be an amount equal to the dividends received deduction claimed with respect to dividends received on the leveraged stock. The proposal would not apply in cases where the leveraged stock represents an interest in a corporation in which the taxpayer holds an 80 percent or greater interest.

(2) Dividend distributions of appreciated property

Under present law a corporation is generally subject to the corporate income tax on gains realized on nonliquidating sales of its property. The tax is imposed at ordinary income or capital gains rates, depending on the nature of the asset sold. In addition, distributions to the shareholders of the sales proceeds are taxed as dividends, generally at ordinary income rates, except in certain redemption transactions, in which case the distributions are taxed as capital gains. When a corporation distributes property to its individual shareholders, whether in a capital gain or dividend transaction, the shareholders generally receive a fair market value basis for the property received.

When a corporation distributes appreciated property to its shareholders, the distributing corporation generally recognizes gain on the appreciation, if the distribution is in redemption of its shares or constitutes a partial liquidation. Limited exceptions apply in special situations: certain redemptions made to pay death taxes, redemptions of stock held by private foundations, and redemptions of regulated investment company stock.

A corporation, however, is not subject to tax upon a dividend distribution of appreciated property to its shareholders (except to the extent of recapture of depreciation or other previously claimed tax benefits). The failure of current law to tax dividend distributions of appreciated property causes an inconsistency in treatment between an asset sold by the corporation to a third party, which is fully taxable to the selling corporation, and a dividend distribution of the same asset to the corporation's shareholders. Thus, when a corporation distributes property with a basis of $100 and a value of $300, the $200 of appreciation escapes the corporate income tax.

The absence of a corporate level tax with respect to such distributions is inconsistent with the usual rules for the taxing corporations and their shareholders. Generally, a corporation is subject to tax on the profits derived from its operations, including gains derived from dealing in property. Shareholders are also subject to tax on receipt of the corporation's profits. Exempting the corporation from tax on a distribution of appreciated property in kind is inconsistent with this structure, since it allows the shareholder to receive the full value of the appreciated property at the cost of only one level of tax (the dividend tax at the shareholder level). Thus, these distributions may be used to avoid the corporate tax. While we think nonrecognition may be appropriate in the case of liquidating distributions where the corporation's business activities will cease, it is not appropriate in the case of ordinary dividend distributions.

The Administration's proposal thus requires that a corporation recognize gain on the distribution of appreciated property to noncorporate shareholders in an ordinary dividend transaction. The amount and character of the gain would be determined as if the corporation sold the property for its fair market value on the date of the distribution. This rule would not apply in the case of a dividend to a corporate shareholder where the basis to the recipient is carried over from the distributing corporation. Similarly, in general, no tax would result on the distribution of stock of a controlled subsidiary, the receipt of which is tax free to the shareholder under section 355. In addition, the other nonrecognition provisions contained in present law with respect to redemptions of stock with appreciated property would continue. The proposal generally will apply to distributions made after the date of enactment. However, under a transition rule, transactions substantially under way on February 1, 1984 will not be covered by the proposal.

(3) Foreign-related transactions

The Administration's corporate reform proposals contain several important measures concerning foreign corporations. They are intended to curtail abuses with respect to the transfer of property to foreign corporations and certain transactions involving avoidance of the controlled foreign corporation provisions of the Code.

The principal proposal concerns transfers of property to foreign corporations. Section 367 of the Code generally denies nonrecognition of gain treatment to transfers of property by U.S. persons to foreign corporations in certain otherwise tax-free exchanges unless the transferor obtains a ruling that the transfer did not have the avoidance of Federal income tax as one of its principal purposes. The purpose of this rule is to eliminate the opportunity for permanent tax avoidance through the transfer of appreciated property outside the taxing jurisdiction of the United States. The standards for granting these rulings are set forth in published Internal Revenue Service guidelines.

A court decision has implied that a tax avoidance purpose for a transfer must be greater in importance than any business purpose before section 367 will apply to prevent a tax-free transfer of property to a foreign corporation. This narrow interpretation of the statute has made it more difficult to restrict the ability of U.S. persons permanently to avoid U.S. tax on appreciated property by simply transferring the property to a foreign corporation. A legislative change in this area is needed to ensure that tax avoidance is not permitted and to assist in the efficient administration of the law.

Our proposal would eliminate the "principal purpose" test in the statute and basically would codify the Internal Revenue Service's ruling guidelines. In addition to providing clear rules on when tranfers of property to foreign corporations will and will not be tax free, the proposal will have the added benefit of removing the need for a ruling process. This will significantly reduce the administrative burden on both taxpayers and the Internal Revenue Service.

A special problem in this area exists with respect to the transfer by U.S. persons of intangible assets (patents, trademarks, business know-how) to foreign corporations. Under its published ruling guidelines, the Internal Revenue Service generally has issued favorable rulings for tranfers of patents and similar intangibles for use in an active trade or business of the foreign transferee corporation. A number of companies have adopted a practice of developing patents or similar intangibles at their facilities in the United States. When such intangibles appear ready for profitable exploitation, they are transferred to a foreign manufacturing subsidiary. By engaging in such practices, the transferor U.S. companies attempt to reduce their U.S. tax liability by deducting substantial research and experimentation expenses (and claiming substantial R&E credits) for the costs associated with the development of the transferred intangible and by transferring the intangible to a related corporation in a low-tax jurisdiction at the point of profitability.

A similar problem existed prior to the Tax Equity and Fiscal Responsibility Act ("TEFRA"), with respect to U.S. corporations operating in Puerto Rico. In TEFRA, Congress acted to limit the ability of U.S. corporations to avoid U.S. tax through the transfer of intangibles to corporations entitled to the special benefits of operating in

Puerto Rico. We feel that it is also important to limit that ability when transfers of intangibles are made to foreign corporations. There is obviously no policy reason to provide a greater incentive for operations in low-tax foreign countries than is provided for the encouragement of employment and capital development in Puerto Rico.

The proposal would generally require the transferor to include in income annually an amount that would equal a reasonable royalty for the use of the transferred intangible. This rule would reduce the mismatching of deductions and income currently available. The transferor would continue to have the alternative of selling the intangible to the foreign corporation.

(4) Miscellaneous technical proposals

We are making several proposals that are aimed at highly intricate transactions structured to permit taxpayers to avoid existing restrictions in the Code on the availability of tax benefits. The General Explanations describe these transactions and how we would deal with them in detail; therefore, I will describe them only briefly. I wish to emphasize, however, that these proposals deal with significant defects in current law and are important matters for this Committee's consideration.

Investment funds.—Certain investment funds have relied on a technical defect in the computation of the accumulated earnings tax to retain earnings instead of making distributions to the funds' shareholders. By making no distributions, the shareholders of the funds can have the return from the investment taxed at favorable capital gains rates. We are proposing an amendment to the accumulated earnings tax provision to remedy this defect.

Short sales.—Currently, taxpayers may engage in short sales of stocks that are about to pay large dividends in order to create ordinary losses and offsetting short-term gains—which in turn can be offset against capital losses which otherwise would not be usable. We are making proposals that will insure that short sale transactions are taxed in accordance with their economic substance.

Capital gain dividend of mutual funds.—By acquiring shares of a regulated investment company shortly before a capital gain dividend is paid, a shareholder may receive long-term capital gain income and then claim an offsetting short-term capital loss when the shares are sold at a loss (the shares can be expected to drop in value by the amount of the dividend), thereby effectively converting unrelated short-term gains to long-term gains. Our proposal would require that the taxpayer hold the shares of the fund for at least six months to obtain long-term treatment for these capital gain dividends.

Receipt of extraordinary dividends by corporations.—When a corporation receives an unusually large dividend on stock, it may exclude from income 85 percent of the dividend and then sell the stock for a loss approximately equal to the dividend, thereby producing substantial tax benefits without risk or cost. We are proposing that if a corporation does not hold shares for at least 1 year, it must reduce its basis in the shares by the amount of any "extraordinary" dividend, thereby eliminating the artificial tax loss.

Collapsible corporations.—To significantly reduce the effective tax rate on sales of inventory, a taxpayer may establish a corporation that recognizes approximately one-third of the gain to be derived from the sale of the inventory and then liquidates. The taxpayer then claims long-term capital-gain treatment on the gain recognized on the liquidation. We are proposing that the collapsible corporation rules of current law, which were enacted to deal with transactions of this type, be tightened to require at least two-thirds of the inventory gain to be recognized by the corporation to avoid ordinary income at the shareholder level.

Corporate distributions of partnership interests.—Some taxpayers have asserted that corporate distributions of interests in partnerships that hold property subject to the recapture tax provisions of the Code escape taxation at the corporate level. We are proposing that a corporate distribution of an interest in such a partnership (or sale of an interest in the partnership pursuant to a plan of complete liquidation) be treated as a direct distribution or sale of the corporation's share of the recapture property (and similar items) held by the partnership. The corporation would be taxed, however, only to the extent that it would have been taxed upon a direct sale or exchange of the partnership interest.

Expatriation of U.S. corporations.—Recently, a U.S. corporation arranged to become a subsidiary of a foreign corporation that was formerly the U.S. corporation's subsidiary, with the result that U.S. tax on the earnings of the foreign subsidiary was avoided. Our proposal requires the recognition of deferred earnings when such transactions occur.

III. PARTNERSHIP AND OTHER PROPOSALS

A partnership is not a taxable entity for Federal income tax purposes. Its taxable income or loss is determined at the partnership level and is passed through to the partners to be reported on the partners' returns. This pass-though method of taxation has made partnerships a favored tax shelter vehicle. Certain tax shelter techniques have been developed that turn on specific provisions of the Code governing the taxation of partnerships. Among the most troubling of these techniques are those involving partnership allocations, contributions, and distributions. Equally disturbing are tax shelters that are based upon charitable contributions of property. Finally, we are very concerned about certain current techniques involving like-kind exchanges of partnership interests and other property.

(1) Abusive partnership allocation/distribution arrangements

Section 704(a) of the code provides that a partner's distributive share of partnership income, gain, loss, deduction, or credit (or item thereof) is determined by the partnership agreement, except as otherwise specifically provided in the Code. Under section 704(b) of the Code, which was amended as part of the Tax Reform Act of 1976, if an allocation to a partner under the partnership agreement lacks "substantial economic effect" it is disregarded and each partner's distributive share is determined in accordance with the partners' respective interests in the partnership (taking into account all the facts and circumstances).

Partnership distributions of money to a partner generally are tax-free to the extent of the adjusted basis of the partner's partnership interest. The partner, however, must reduce the basis of his partnership interest by the amount of money received.

Some partnerships have taken the position that these allocation and distribution rules can be used to transform what would otherwise be a capital expenditure into the equivalent of an immediately deductible expense. An example that illustrates the results claimed by taxpayers under these arrangements is contained in our General Explanations.

If these allocation/distribution arrangements are valid, they may be used to compensate partners for all types of services performed for the partnership to employ this technique. A partnership also may attempt to use this technique to convert the price paid for nondepreciable property into immediate deductions.

Although we believe that these arrangements are susceptible to attack under present law, we are proposing specific clarifying amendments to ensure that these transactions are taxed correctly. Under our proposals any allocation of income to a partner under the partnership agreement would be disregarded if the allocation is related to a contemporaneous distribution to the partner and a direct payment to the partner in lieu of the distribution would be required to be capitalized. The purported distribution would be recharacterized as (i) a capitalizable fee from the partnership in exchange for the partner's services, (ii) additional purchase price paid by the partnership in exchange for the partner's property, or (iii) a capitalizable payment of another type made to the partner in a non-partner capacity.

(2) Abusive partnership contribution/distribution arrangements

Another disturbing technique involves the contribution of property to a partnership, followed shortly by a partnership distribution of money or other property to such partner. Although in substance this transaction is often either (i) a disguised purchase and sale between partners, or (ii) a part-contribution and part-sale to the partnership, the partners may characterize the arrangement as a contribution and distribution in order to defer recognition of gain to selling partner. An illustration of the most transparent of these arrangements is contained in our General Explanations.

The Service has argued that the relevant Treasury regulations under Code sections 721 and 731 require these arrangements to be recharacterized as sales. Most courts, however, have insisted on respecting the form that the partners have used in carrying out the transaction. Thus, in order to tax these disguised sales properly, we are proposing that the Code be amended to treat these contribution/distribution arrangements either as a sale among partners or where appropriate as a part-sale and part-contribution to the partnership, irrespective of the form of the transaction.

(3) Abuses involving retroactive partnership allocations

Under section 706(c)(2)(B) of the Code, adopted as part of the Tax Reform Act of 1976, items of partnership income, gain, loss, deduction, and credit attributable to the portion of a partnership's taxable year that precedes a partner's entry into the partnership generally may not be allocated to that partner. Partnerships have developed two techniques that some claim allow them to avoid this prohibition on retroactive allocations. The first technique involves the use of a two-tier partnership arrangement (i.e., a "parent" investor partnership that owns a predominant interest in a "subsidiary" operating partnership) in conjunction with an "interim closing" of the partnership's books and records. Taxpayers have claimed that this arrangement permits a large portion of the subsidiary partnership's operating losses for the entire year to be allocated to the year-end investors in the parent partnership. This technique is illustrated in an example contained in our General Explanations.

Although the Internal Revenue Service specifically rejected this technique in Revenue Ruling 77-311, many partnerships continue to use this retroactive allocation technique. Our proposal would require income, gain, loss, deduction, and credit passing from the subsidiary partnership to the parent partnership to be allocated equally among the days in the parent's taxable year for which it has an interest in the subsidiary.

The second retroactive allocation technique involves a partnership on the cash method of accounting that incurs but does not pay substantial expenses (e.g., interest, rent, compensation, taxes, etc.) throughout the taxable year, admits tax-shelter investors late in the year, and then pays the previously incurred expenses. The partnership claims that, by using an "interim closing" of the books, the full year's deductions can be allocated to the late-entering investors because these investors were partners when the expenses were paid. Although the Internal Revenue Service has argued in several cases that, under assignment of income principles, expenses incurred prior to the investors' entry to the partnership may not be deducted by such investors, the courts thus far have rejected the Service's position.

The Administration is proposing that these previously incurred but unpaid expenses be allocated to the periods of the taxable year during which they were incurred, regardless of the time at which the expenses are paid. Expenses incurred in a prior taxable year would be considered to be incurred on the first day of the taxable year in which they are paid.

These changes would clarify the clear policy against retroactive partnership allocations that the Congress adopted in 1976.

(4) Property contributed to a partnership

Under section 704(c)(1) of the Code, a partner's allocable share of depreciation, depletion, and gain or loss on property contributed to the partnership is, as a general rule, determined as if the partnership had purchased the property. However, section 704(c)(2) of the Code validates an agreement among the partners to allocate depreciation, depletion, or gain or loss in a manner that takes into account any difference, at the time of contribution, between the adjusted tax basis of the contributed property and its fair market value.

Under present law the character of property contributed to a partnership, as well as any gain or loss resulting from the sale or exchange of such property, is determined at the partnership level. This determination is generally made with reference to the relationship of such property to the partnership's activities.

Taxpayers have attempted to use section 704(c)(1) of the Code to shift among partners, on a noneconomic basis, the unrealized tax burden or benefit that is inherent in contributed property at the time of contribution. An example that illustrates the income and loss shifting possibilities that can result from the operation of this provision is contained in our General Explanations.

Although the issue is not free of doubt, many believe that these income and loss shifting allocations are sanctioned by section 704(c)(1) of the Code and are not subject to the current standards of section 704(b) (allocations must possess substantial economic effect or be in accordance with the partners' interests in the partnership). We believe that when Congress enacted section 704(c)(1) as part of the 1954 Code it did so to provide administrative simplicity. It is highly unlikely that Congress intended the provisions to permit wholesale shifting of income and loss, and it surely did not envision that the rule would be used as a tax shelter device. Accordingly, we are proposing that the rule contained in section 704(c)(2) of the Code, which allocates depreciation, depletion, or gain or loss on property contributed to a partnership so as to take into account the difference at the time of contribution between the adjusted tax basis of such property and its fair market value, be made mandatory (with certain minor modifications).

Certain other abuses have developed with respect to property contributed to partnerships. Assets that are ordinary income assets (inventory and unrealized receivables) in the hands of a partner may, in certain instances, become capital assets in the hands of the partnership, with the result that gain from the sale of such assets may be converted from ordinary income into capital gain. Likewise, taxpayers have argued that capital assets with built-in losses can be contributed to a partnership that is a "dealer" in such assets, with the result that losses from the sale of these assets may be converted into ordinary losses.

We are proposing that (i) built-in losses on contributed capital assets retain their character as capital losses in the hands of the partnership for a period of five years from the date of contribution, and (ii) property that is inventory in the hands of a contributing partner (or is held for sale to customers in the ordinary course of the contributing partner's trade or business) retain its character as such in the hands of the partnership for a period of five years from the date of contribution.

(5) Like-kind exchange problems

Under section 1031 of the Code, gain or loss is not recognized on an exchange of like-kind property held for use in a trade or business or for investment, except to the extent that the taxpayer receives property that is not like-kind (boot). Rather, the potential gain is deferred and recognized when and if the property received in the exchange is sold. In *Starker* v. *United States,* 602 F.2d 1341 (9th Cir. 1979), the Court of Appeals held that an exchange of property in return for like-kind property to be designated by the taxpayer during a period of up to five years in the future qualifies as a like-kind exchange under section 1031 if the taxpayer eventually receives like-kind property in settlement of the other party's obligation in the exchange.

We are concerned about the proliferation of exchange transactions in which taxpayers receive a contract right that permits them to designate like-kind property to be received in the future. In our view, if like-kind exchange treatment were available for this transaction, it would unjustifiably permit taxpayers to avoid recognition of gain on dispositions of property.

When a taxpayer exchanges property for like-kind property in a simultaneous exchange, nonrecognition of gain arguably is justified because of the difficulty of placing a value on the properties exchanged and because there is an immediate reinvestment in like-kind property. There is no difficulty, however, in establishing the value of properties in a deferred like-kind exchange. Where a taxpayer is given the right to designate properties to be received in the future, the property he has transferred must be valued at a specific dollar amount in order to determine the aggregate value of the properties that he may receive in the future. Thus, the taxpayer's gain may be accurately measured in the year of the original transfer.

More importantly, the qualification of deferred like-kind exchanges under section 1031 also expands significantly the ability of taxpayers to avoid recognition of gain on deferred payment sales. In contrast to the rules of section 1033 (relating to replacement of property involuntarily converted) and section 1034 (relating to the replacement of a personal residence), deferred like-kind exchanges under section 1031 have no express statutory limit on the time in which the nonrecognition transaction must be completed. With minor restrictions, taxpayers may be given the option of designating like-kind property or of receiving cash payments. Thus, taxpayers may defer taxation on dispositions of property for an indefinite time even though the right to receive cash is present. Furthermore, when a contract permits a party to receive like-kind property to be designated, he effectively has a continuing right to receive cash upon request. The other party that has agreed to buy and deliver such property generally would have no economic reason not to pay cash.

Finally, deferred like-kind exchanges raise administrative problems that would require complex solutions. These problems would arise primarily from differences in the treatment of liabilities and allocation of basis under the like-kind exchange provisions and the installment sales provisions. A rational accommodation of these two sets of rules would require that the final determination of the tax treatment of the transaction be suspended until all exchanges and payments required by the agreement have been completed. Thus, the tax consequences of deferred exchange transactions would be unknown for many years.

In view of these problems, we are proposing that section 1031 be amended to provide that property to be received more than 90 days after property is relinquished cannot qualify as like-kind property.

We also believe that like-kind exchanges of partnership interests should be prohibited. Substantial problems of complexity and administrability arise when section 1031 of the Code is applied to exchanges of partnership interests. For example, if an interest in one partnership is exchanged for an interest in another partnership, it is not clear what portion of the underlying assets of the two partnerships must be of a like kind in order for section 1031 to apply. It is arguable that the like-kind test should be applied on an asset-by-asset basis, which would create an extremely complicated and difficult analysis in many cases. In addition, we understand that the like-kind exchange provision has been used by some taxpayers is conjunction with certain highly technical partnership provisions to dispose of "burned out" tax shelter investments without recognition of income attributable to liabilities in excess of basis.

In view of these problems, we are proposing that like-kind exchange treatment be denied explicitly for exchanges of partnership interests in different partnerships. Indeed, there is a serious question whether the like-kind exchange provisions was ever intended to apply to exchanges of partnership interests. Section 1031 does not apply to exchanges of stock, certificates of trust or beneficial interest, or "other securities or evidences of . . . interest." Partnership interests can be viewed as investment interests similar to these excluded items. We do not believe a statutory distinction between limited partnership interests and general partnership interests is warranted since the state law distinction is often factual and may vary from state to state. In any case, the problems relating to complexity and administrability described above may be equally difficult for both categories of partnerships.

(6) Related party transactions

To prevent tax shelter promotions from creating artificial losses and taking advantage of the rules relating to the time for reporting income and deductions, we have proposed that certain modifications be made to the related party rules. We have previously testified regarding these provisions in connection with H.R. 3592 (which has now been included in H.R. 4170) before the House Ways and Means Subcommittee on Select Revenue Measures on September 21, 1983. Our current proposal extends those provisions by applying the expense disallowance rule not only where the mismatching occurs because the payor utilizes the accrual method of accounting and the payee utilizes the cash method, but any time there is a mismatching of a deduction with the corresponding inclusion in income between related persons. For example, the proposal would apply where the payor makes a cash payment and a related payee defers reporting the income by use of the completed contract method of accounting or sections 455 or 456 (which relate to the deferral of prepaid subscriptions and dues income). In addition, our proposal extends both the loss disallowance and expense disallowance rules (as well as other provisions of the Code that define related parties as those to which the expense and loss disallowance rules apply) to transactions between: (i) two trusts more than 50 percent of the value of which are beneficially owned by the same persons; and (ii) a trust and a partnership or corporation more than 50 percent of the value of which are beneficially owned by the same persons.

(7) Charitable contributions

The Administration is concerned with the effects of the current charitable deduction rules for two different reasons. We believe that certain portions of the current rules are too restrictive and that other portions are too liberal.

First, let me discuss the rules we would liberalize. Under current law, the amount an individual is permitted to deduct for contributions to public charities for any taxable year generally is limited to 50 percent of his adjusted gross income ("AGI"). Where a taxpayer's charitable contributions exceed this and certain other limitations, the excess is treated as a charitable contribution in each of the succeeding 5 years until it is used.

The Administration is concerned that the combination of the 50 percent of AGI limitation and the limited carryover period for unused deductions may inhibit potential donors from making large gifts because they might never realize the full tax benefit from those gifts. Consistent with its continuing support of volunteerism and private giving, the Administration proposes to liberalize these two rules by increasing the AGI limitation to 60 percent and the carryover period to 15 years. We believe these liberalizing changes will remove unnecessary impediments to charitable giving.

The Administration's proposal also addresses abuses of the charitable deduction through "tax shelter giving." These transactions, which often are tantamount to fraud, involve gifts of property the value of which is not readily ascertainable.

Let me give an example:

An individual taxpayer in the 50 percent bracket purchases precious gems from a promoter at a "wholesale" price for the sole purpose of donating the gems to a charity at an inflated value. The promoter represents to the individual at the time of purchase that the gems will be worth 500 percent of their "wholesale" price after twelve months. The individual holds the gems for twelve months and one day after the purchase and then donates them to a public charity after obtaining an appraisal from an associate of the seller that the gems are worth 500 percent of the original purchase price. The individual deducts the full appraised value, claiming tax savings of two and one-half times his investment.

This type of transaction is beneficial to taxpayers largely because current law does not require donors to pay capital gains tax on the appreciation in donated property, even though they would have to pay capital gains tax if they sold the property and donated the cash proceeds. Instead, current law provides that if the donor holds the donated property for over one year, he generally may deduct the full fair market value of the contributed property.

Because charities depend upon this tax incentive for many donations, the Administration is not proposing to tax donations of appreciated property as if the property had been sold and the proceeds donated. Rather, we propose to lengthen the current one-year holding period to three years for gifts of property other than securities traded on an established market. This proposal would disallow a charitable deduction for the appreciation in donated property if the donor has held the property for less than three years. If the donor made charitable contributions of property prior to the lapse of the three-year period, the donor could, of course, claim a charitable contribution for an amount equal to his cost for the property.

The Administration also proposes to extend the penalty for overvaluation of property to apply to charitable donations without regard to how long the donor has held the property. The Administration believes that these changes will help in its efforts to stop abusive tax shelters without adversely affecting legitimate donors.

This concludes my prepared remarks. I would be pleased to answer any questions that you might have.

Chairman ROSTENKOWSKI. Thank you, Mr. Secretary.

Mr. Conable will inquire.

Mr. CONABLE. Buck, this is a pretty eclectic area. I think there is a ringing in our ears and flashing lights in front of our faces when you describe some of these rather complicated practices. Sam Gibbons and I have a bill relating to the decommissioning costs of utilities which has something to do with the time value of money.

As I understand it, what you are saying is that you couldn't deduct those costs now at the full amount.

Mr. CHAPOTON. That is correct.

Mr. CONABLE. What you are saying is, it ought to be apportioned under some formula along the economic life of the asset that is going to be subject to the decommissioning cost. Now, is that the principle you are generally advancing here, to avoid massive deduction now for something which is not really going to take effect until some time in the distant future, and therefore should be apportioned rather than taken now?

Mr. CHAPOTON. Mr. Conable, you are correct partly, that that is a specific example of the problem we are concerned about. If you take the full deduction now for the costs that will be incurred 25 years in the future, you have taken a deduction which overstates the present value of your liability.

Mr. CONABLE. Present value is discounted under your proposal, is that correct?

Mr. CHAPOTON. No, no. We played around with the idea of discounting the deduction, but it simply becomes too complicated. We are proposing that the deduction be deferred and allowed when economic performance occurs. That means in simple terms no deduction until performance occurs some 25 years hence.

Now, at first blush that might look harsh, and it is an item you have got to put the pencil to. We think it reaches the proper economic result.

Mr. CONABLE. But different assets are treated differently.

Mr. CHAPOTON. No, in this proposal, any deduction would be deferred until economic performance occurs.

Mr. CONABLE. Well, let me ask you this. Is there any ground for a different treatment? For instance, the decommissioning costs which you know you are going to have.

Mr. CHAPOTON. That is correct.

Mr. CONABLE. And it is fairly determinable what will be, for instance, the cost in the future of environmental correction of strip mining.

Mr. CHAPOTON. Well, I think we have to specify that the problem does not really occur unless you can state with a degree of great certainty that the liability has been incurred because of activity in the current year and the amount of the liability. Of course, there is a factual question there, but that is the premise we are starting with. We are assuming those facts are being stated, and therefore, I think your statement applies to really almost every case we are dealing with, except in your case the period before which the payment will be made is generally much longer.

Mr. CONABLE. But in some cases, you do not know what the future expense is going to be, and in others you do.

Mr. CHAPOTON. That is correct.

Mr. CONABLE. I was wondering if we do not have some basis for differentiation here among different classes of future costs.

Mr. CHAPOTON. One basis might be, and we have seen these cases where, in fact, the taxpayer is required to set aside funds, where he actually is by law in some cases required to set aside funds. Then it might be rather difficult to say the amount required to be set aside is not available.

Mr. CONABLE. I am queasy about the whole area of utilities anyway, because when we have permitted major deductions of this sort, they have generally been flowed through to the consumers by the rating agencies, and that becomes another issue, of course.

Do you think it is possible, then, to define one rule that could apply to all of these cases?

Mr. CHAPOTON. I think it is. Yes, sir; it is.

Mr. CONABLE. But is it economically reasonable, though?

Mr. CHAPOTON. I think it is economically reasonable. It is economically equivalent if a deduction is taken later and the deduction is usable later. Now that is key. If the deduction, of course, is put to a year the taxpayer cannot use it, then you obviously have a problem. The deduction has to be fully available against tax liability in the subsequent year.

Mr. CONABLE. That is why you are suggesting the loss carryover.

Mr. CHAPOTON. The extended loss carryback, yes.

Mr. CONABLE. Carryback. Yes. Well, thank you. We will have to wrestle with this some, I think.

Chairman ROSTENKOWSKI. Mr. Secretary, in most instances the hearing pamphlet contains recommendations of the Treasury Department. However, there are also some proposals in the pamphlet that the staff of this committee has suggested. I would like to ask that the Treasury Department work closely with our staff in refining both the suggestions of the Treasury Department, as well as those of the Ways and Means Committee staff.

Mr. CHAPOTON. Yes, sir. We have been looking at those closely. We will be happy to work with the staff.

Chairman ROSTENKOWSKI. Mr. Rangel will inquire.

Mr. RANGEL. Mr. Secretary, it has come to my attention that some of your partnership provisions may have an adverse effect on low income and multifamily housing. I would just like to say at the outset that I do not believe the Tax Code is the proper vehicle to use to create housing for low and moderate income people, but obviously it is the only thing that we have coming from this administration.

I was wondering whether you have given any thought to it, or has your staff indicated that there might be a negative impact?

Mr. CHAPOTON. Mr. Rangel, yes. We might as well recognize that several low income housing deals do trade very definitely on tax benefits. For example, the mismatching of income and deductions is a common device used for disposing of low-income housing, and therefore, if you prevent the mismatching of the income and deduction, you are going to have an impact on those types of transactions.

It will have an impact on all similar financial transactions, and therefore we have not proposed any exception for low-income housing. It is, quite frankly, an abuse of the Tax Code. Perhaps the beneficiary of the abuse is low-income housing. Perhaps it is not.

Mr. RANGEL. Well, you know, taking into consideration that there are no housing proposals coming from the proper agency, it would seem to me that you could assist us in not having conflicts, in having us be forced to adopt what could be bad tax policy, but obviously there is a gap here in the housing needs of low and moderate income people, and sometimes your tax reform policies make a lot of sense, but we do not get too much support in trying to reach the objectives that we should have in providing decent housing. It has been explained to me that the administration housing policy is in fact the enterprise zone proposal. Do you intend to bring that back?

Mr. CHAPOTON. Yes; we are pursuing the enterprise zone proposal. I do not believe I would describe it as a housing proposal. We have talked to the people at HUD about the tax proposals, and quite frankly, they have some concerns, as you do, about the impact on low-income housing.

We would like to attempt to quantify that impact and be quite above board on it, but the tax abuse is clear, and I know that you recognize that, Mr. Rangel, and I understand the import of your statement, but I think we are going to stick by these proposals. If the push should be made for more on the housing side, I think that is where it should be.

Mr. RANGEL. Well, you know, one man's incentive is another man's abuse, so I suspect that if you are supporting the enterprise zones proposal, that you might allow these partnership provisions to be at least used in these targeted areas.

Mr. CHAPOTON. We could look at that. Yes, sir.

Mr. RANGEL. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Stark will inquire.

Mr. STARK. Thank you, Mr. Chairman.

Mr. Secretary, in the pamphlet there are four provisions in which I have a particular interest, and I wonder if you could comment. They begin on page 103, and they are the investment tax credit for dairy property known as the Hertz Cow amendment, the Golden Parachute provision, the limitations on depreciation and investment tax credit for expensive automobiles, and limitation on the overpayment of certain Federal excise taxes to Puerto Rico and the Virgin Islands. I wonder if you could comment briefly on those and the administration's position.

Mr. CHAPOTON. Well, Mr. Stark, let me comment on it. The administration has not developed a position on each of these. In the case of the tax credit for dairy products, I think we are reluctant to start disallowing credits where other Federal benefits are involved.

I do not want to say unqualifiedly we would not do that, and indeed that is a line of approach that we have used in the industrial development bond area where you have in that case one tax benefit. The other tax benefit should be reduced.

In this case, where other Federal benefits flow, they flow against an existing set of laws, and I really question whether we ought to then go back and amend the Internal Revenue Code to take that into account, but I think I should say that is really my view, and we have not developed a position on it.

With respect to the Golden Parachute compensation arrangements, I would put that more in the category of a securities problem rather than a tax problem, unless indeed the compensation arranged is excessive.

Mr. STARK. What if it is applied as a gift in effect?

Mr. CHAPOTON. I am sorry?

Mr. STARK. What if it is, in fact, a gift?

Mr. CHAPOTON. Well, if in fact it is a gift, it would be excessive. In other words, it would not be a gift unless it exceeded the value of services, and I think that is well worth looking at, because in some of the reports I have seen in the newspapers, at least, certainly some of those compensation values would be in excess of what we would normally think of as reasonable deductible compensation.

It is going to be difficult, as you well know, to legislate with any specificity in this area, but that does not mean an attempt should not be considered, but I would emphasize that I think there are problems beyond the tax law here.

With respect to limitation on depreciation and investment tax credits for expensive automobiles, that in our view involves two general questions. One, the personal consumption element in business expenses, and second, and related, is whether you have lavish and extravagant costs.

The general rule under section 162 of the code is that a cost that normally is deductible is not deductible to the extent that it is lavish and extravagant. There is no such rule in the depreciation provisions, but if you are going to deal in this area, I question why we would pick out the automobile alone.

Mr. STARK. I would be willing to include any other perks or accouterments that the Treasury wanted to recommend we add.

Mr. CHAPOTON. Well——

Mr. STARK. Office decorations.

Mr. **Chapoton**. That is a good example. If you get into office decoration, who determines what is lavish?

Mr. **Stark**. Well, if you would like to recommend, we could set a dollar limit on that.

Mr. **Chapoton**. I think we are not going to be in a position to recommend that this year, Mr. Stark. [General laughter.]

So I would imagine that our position would be that we would not at this time go along with such a limitation. I recognize the purpose of it. I think it is necessarily a meat ax approach that you have taken.

Mr. **Stark**. The administration has a limitation, do they not, on automobiles used by executives in the administration?

Mr. **Chapoton**. I am sorry?

Mr. **Stark**. Does not the administration have a limit on the size of automobiles that executives may use for executive transportation in the administration?

Mr. **Chapoton**. I am not sure whether there is. There are small cars. I can attest to that. But I am not sure whether there is a limit or not, but I think you are dealing with one small part of a much larger problem, and I really suggest that that is the type of thing that ought to be considered in the fundamental review of the system that we are engaging in now, and then the other one you mentioned was the redistillation payment to Puerto Rico and the Virgin Islands. There is definitely a problem with the law there, and there is definitely a need to amend the rules so that those payments cannot be covered over.

The question is going to be, how much good faith reliance there was on valid rulings issued by the Treasury Department and really determining over what period that should be phased out.

Mr. **Stark**. Is it not a fact that when the Treasury did issue its rulings, that they were unaware of any rebates in the redistillation tax transfer?

Mr. **Chapoton**. Mr. Stark, I do not know that for a fact. I heard that suggested yesterday. The materials I have seen, no, I did not get that from the materials I have read on this, that that would be a factor.

Mr. **Stark**. Thank you very much.

Chairman **Rostenkowski**. Mr. Downey will inquire.

Mr. **Downey**. Thank you, Mr. Chairman.

Buck, I am no expert on any of this. Maybe you can give me a little help. Who are we going to be seeing in the next couple of weeks disputing your analysis? I have Tax Notes before me. I am an avid reader of Tax Notes. In it, Mr. Sunley addresses this important question of decommissioning costs and the cost of dismantling oil rigs. There are also concerns about some of the casualty insurance company losses and reclamation losses. He basically says that your analysis of the economic impact is off frankly, and that they should be treated as capital costs. I would like you to respond. I do not know if you have seen the article.

Mr. **Chapoton**. I have not read it. I know about the article, and our people have reviewed it, and quite frankly, we disagree with Mr. Sunley's analysis, even though we have the greatest respect for Mr. Sunley, who is a former member of the Treasury Department team.

Mr. **Downey**. Can you tell me, Buck, how you disagree?

Mr. **Chapoton**. No, Mr. Downey, I cannot without personally reviewing the article, which I have not done. But let me just say that it is not a problem that can be treated lightly, and we have not treated it lightly. Indeed, we have testified on this two other times, and there will be more testimony before a subcommittee of the Ways and Means Committee on Friday.

At first blush, when I tell you that the expenses relate to this year, even though they will be incurred in a later year, your initial reaction is, that expense ought to reduce income this year, and I think we would agree if the expense is a discounted expense, but when you start down the road of calculating the proper amount of the discount amount, it is a thicket that you cannot come out of.

If you turn and defer the deduction until the economic performance has occurred, until the dismantling of the plant occurs, we calculate you reach the same economic result as if you had discounted and allowed the deduction in the earlier year.

Once we reach that conclusion, our only concern has to be that the amount deducted in the later year in fact be usable, and that is what we want to insure, and we think we reach the proper result.

Mr. **Downey**. Basically one of the things I learned when I came on this committee is the desire on our part, especially when you deal with economic matters, to be economically neutral. Can you state the basis for me that these attempts that you are making that I am inclined to be supportive of move in the direction of economic neutrality?

Mr. **Chapoton**. That is the purpose.

Mr. **Downey**. Can I ask another question then with respect to this whole question of tax shelters? Do we see more tax shelter activity as a result of what we did in 1981 or less, in your opinion?

Mr. **Chapoton**. I do not know whether it is as a result of 1981 or not. We see an awful lot of tax shelter activity. The thought was that a rate reduction would diminish it. I think it diminished it for a lot of taxpayers, but awareness of availability of tax shelters and the objection to paying taxes simply results in tax shelter activity which sometimes from an economic standpoint makes absolutely no sense and is very questionable from a legal standpoint.

Mr. **Downey**. I admire the work you do, and I do not want to get into a political argument, but I want to make a point here that I think we should think through. And that is this notion that Secretary Regan first came before this committee with, that supply side economics would do great things for us.

It was said that it would reduce marginal tax rates, that there would be a big boom in investment, savings, and work, that moving the top rate down from 70 to 50 would inexorably lead to people not being involved in this sort of tax shelter.

I mean, is it not fair to say at this point that some of the expectations that we had about what we would do in 1980 with the Tax Code changes just have not lived up to their prior selling points?

Mr. **Chapoton**. I think, Mr. Downey, you would have to examine it item by item, but it is certainly clear that the accelerated deductions for investment, for example, have improved the climate for investment in plant and equipment, and we are finally seeing that now that we are pulling out of the recession.

It is certainly clear that the reduction of the top rate did have an impact on shelters in the early years, and I think the shelter people that I talked to, the traditional shelter, that is not a four for one writeoff, they still feel the impact of that. But what we are seeing is more of what I would describe as the abusive tax shelter, the highly leveraged tax shelter.

Mr. DOWNEY. But can we make the point, and I think it is important to make, that this notion that the cutting of revenue would lead to a burgeoning economy that would make up for the loss in revenue just frankly has not happened.

Mr. CHAPOTON. The cutting of rates would lead to a burgeoning? I think you have to be careful. We did not sell it originally, and I would emphasize this, we did not sell the tax cuts as in the short run giving enough reflow, giving enough increased activity to make up for the taxes cut. In the short run you have to also reduce the outlay side of the budget, and that is what we also proposed.

Mr. DOWNEY. Thank you very much.

Chairman ROSTENKOWSKI. Mr. Russo will inquire.

Mr. RUSSO. Mr. Chairman, I have no questions.

Chairman ROSTENKOWSKI. Mr. Pease will inquire.

Mr. PEASE. Thank you, Mr. Chairman.

First, Mr. Secretary, I would like to commend you and the Department for your initiative in bringing this to our attention. It seems to me that it is clear to everyone that we are going to have to raise a lot of revenue in the next couple of years if we are really going to reduce the deficits, and as far as I am concerned, we certainly ought to turn to the curbing of abusive tax shelters and other tax loopholes before we go inflicting a sales tax or an income tax surcharge or anything else on the American public. I dare say you are likely to agree with that.

I guess if one were cynical, and sometimes one tends to be cynical, one would assume that high income people will always be trying to shelter their income, and that as you close certain avenues to them, they will find other avenues, and therefore the question is, do you really raise $12 billion over 3 years by enacting the package of reforms that you have before us, or do the high income persons and those who market tax shelters simply turn to other avenues?

Mr. CHAPOTON. Well, Mr. Pease, that is a fair question. I think when you cut the avenues down, the avenues for tax avoidance down, you do obviously have a revenue impact. You do shift people to other activity, but there are already people in those other activities, so you do have an overall revenue gain.

I think the question that you are raising is indeed will we see new transactions develop? I think we will. We just have to stay abreast of them. Or finally, we should look at a fundamental change in the system that avoids the necessity of this.

Mr. PEASE. Will these proposals that you have, if they are enacted in total, tend to complicate or simplify the Tax Code?

Mr. CHAPOTON. Unquestionably, where they apply, they will tend to complicate, in most cases would have some complicating effect. That is why every attempt has been made particularly in the time value of money changes to provide exceptions so they do not apply to the everyday taxpayer in normal transactions and apply principally to large tax transactions, tax shelters, and otherwise, where very sophisticated planning is involved.

Mr. **Pease**. So in an effort to close off abusive tax shelters, we are going to further complicate a tax code that many people feel is already too complicated.

Mr. **Chapoton**. I do not think we need to apologize when we complicate the Tax Code for very complicated transactions, and that is the intent here.

Mr. **Pease**. Do you think that the continued interest in tax shelters—I guess you would say accelerated interest in abusive tax shelters—reflects a feeling that the tax rates are still too high?

Mr. **Chapoton**. Mr. Pease, I do not know. There certainly is a temptation to reach that conclusion. I think it might well partially reflect that. I think clearly the interest in the late seventies reflected that when inflation drove people into higher brackets. People that never would have considered tax shelters suddenly realized they were in the 40, 45 percent tax bracket, or 50 or 55 percent tax bracket, and they had to spend more of their time reducing that than working at their primary occupation.

We have now reduced rates to some extent, but people will still think that rates are high, so I think we ought to continue the effort to broaden the tax base and to lower rates further, if possible.

Mr. **Pease**. What are your thoughts on dealing with those who devise and market tax shelters, particularly abusive tax shelters, when clearly the average citizen, even the average citizen with $150,000 a year, does not dream up these devices by himself? Somebody is making a lot of money poring over the Tax Code, figuring out a system, and then marketing the system, which may be a new element in the next few years. What are your thoughts on that?

Mr. **Chapoton**. Well, in 1982 in TEFRA the Congress and this committee adopted several penalty provisions dealing with exactly that situation. I think they will help, and particularly when they are understood more fully. The substantial understatement penalty, for example, which is in effect a no-fault penalty, if you understate your tax liability by more than 10 percent without substantial authority for doing so.

There are also rules directly aimed at the tax shelter promoter. There is a proposal, I think, being considered by the staff of this committee which would go further, aimed at the promoter, and we would like to look at that as well.

Of course, the problem is distinguishing between a shelter which is abusive and one which is not, and I think you do have to be careful.

Mr. **Pease**. Thank you.

Chairman **Rostenkowski**. Mr. Campbell will inquire.

Mr. **Campbell**. Thank you, Mr. Chairman.

Mr. Chapoton, I have two questions that are general but in a specific area. One is this. First, in the number of audits that you are doing, you mentioned a while ago that there seems to have been some outbreak in tax shelters or new types of tax shelters.

Is this taking more time of agents, and is this the reason that we, in effect, now have had a decline in the number of returns that we have been able to audit, even though we have had an increase in personnel?

Mr. CHAPOTON. IRS is clearly devoting substantially more of its resources to audit of tax shelters and dealing in tax shelters. The answer is yes.

Mr. CAMPBELL. Well, would you tell me what essentially it would take other than obviously some of the changes you propose to keep us somewhere near the levels of, say, 1979 or 1980, which was about 2-point-something percent in audit returns as opposed to about 1.5 now. What would it take in manpower, the increased manpower of a couple of thousand?

But we are going in a different direction, I guess, after tax shelters. But is the return there? And what does it take for us to be able to look at enough of the overall returns to make sure we not only get these tax shelters but others?

Mr. CHAPOTON. Mr. Campbell, I could not say. We could get that information from Commissioner Egger, but I could not say what new resources or reallocation of resources would be required. I know in many discussions with him on this problem that they are generally pleased with their increased capability in dealing with information returns, and therefore the audit coverage can decline without the concern to some extent.

Mr. CAMPBELL. You now target better in areas where you think there is abuse?

Mr. CHAPOTON. That is correct. And we can send out automatic statements indicating failure to report problems, but that does not get away from the fact that the tax shelter audits have drained tremendous amounts of IRS resources, and are clogging the tax court. We have made a lot of changes in attempts to deal with that, for example, the partnership audit rules which were adopted in 1982. IRS has other ideas, frankly, to deal with it, too.

Mr. CAMPBELL. Let me ask you this in the same vein. The Senate Finance Committee, I believe, passed a proposed 50 percent interest penalty on deficiencies, and that is pending, as an encouragement to do something in abusive tax shelters. Would you speak to that and tell me whether that would do any good, not do any good, or what?

Mr. CHAPOTON. Well, it might do some good if you can define in a precise way which class of tax shelters would be subject to the higher rate of penalty. We have been rather reluctant to go that way, though. The interest charge is simply designed to be on both sides, the true cost of the loss of the use of the money, both to the government or the taxpayer, and it seems our initial reaction anyway is that that ought to stay that way.

Mr. CAMPBELL. I have some concern over that, too, but it having passed over there, I was just interested in getting your reaction to it. Thank you, sir.

Chairman ROSTENKOWSKI. Mr. Flippo will inquire.

Mr. FLIPPO. Thank you, Mr. Chairman.

Mr. Chapoton, I have several areas of concern, but I just wanted to direct your attention to page 16 of your testimony to see if I could get some clarification. The last paragraph there dealing with leveraged stock investments by corporations, in that statement, the general explanation of your revenue proposal, it is suggested that the disallowance of the interest deduction be limited to only those cases where the borrowing would not have been incurred but for the purchase of the stock.

As you know, virtually all of the corporate investors that are making those investments have debts on their balance sheet, and while your explanation states that the mere simultaneous existence of a corporate line of credit and the holding of portfolio stock would not result in the interest deduction disallowance, it does not specifically outline the necessary criteria for triggering this interest deduction allowance.

Could you elaborate on that? Would you cite those cases in which this proposed interest deduction disallowance would be triggered?

Mr. CHAPOTON. Well, Mr. Flippo, the intent is to apply a "but for" test, that is, that the disallowance would not apply unless it can be shown that but for the acquisition of this stock, this debt would not have been incurred.

Mr. FLIPPO. May I give you an example? Let us say that someone managing a portfolio invests $100,000 in a preferred stock in a utility company on one side, and the corporate treasury on the same day borrowed $1 million. Would you suggest that he need only borrow $900 million?

Mr. CHAPOTON. Well, you have got a factual question. The question would be whether or not the borrowing would have been made without the investment.

Mr. FLIPPO. That is what I am trying to understand. Will the Treasury make that determination? And when will the Treasury make the determination? What criteria can an investor use when he makes the decision to invest $100,000 and the corporate treasurer is doing something over here? What are the things that relate those two?

Mr. CHAPOTON. Well, I think the clearest case would, of course, be when the corporation decides to make an investment and goes out and says, I am going to make this investment and I am going to borrow these additional funds to make this investment.

In that case, I think, as our testimony described in some detail, you have really got to deal with it. You have clearly got a deduction for the interest and only 15 percent of the income is included from the investment, but if it is part of an ongoing investment operation where debt is being incurred from time to time, then it would not apply. So, I think it is just going to be a factual question that you cannot borrow for that stated purpose.

Mr. FLIPPO. I guess the point that I am trying to make also is the uncertainty that that change introduces into the capital markets and the negative impact that it could have upon financing. For instance, I suppose that one of the areas of the economy that uses preferred stock, for instance, as much as any other is probably the utility industry.

Mr. CHAPOTON. Yes.

Mr. FLIPPO. And the change in this law may result in an increased cost of capital to utilities if in fact the funding that is anticipated over the next few years would not be available, if you have a law change. I think those are rather serious ramifications that we need to look at very carefully, and we need to have it spelled out as much as possible, or we need language here that allays the uncertainty as much as humanly possible.

Mr. **Chapoton**. I would certainly agree with that. I think we might be able to do it in a negative way. That is, that these transactions, these situations would not be covered.

Mr. **Flippo**. I have many other areas, Mr. Chairman, but I will cease at this time. Thank you.

Chairman **Rostenkowski**. Mr. Duncan will inquire.

Mr. **Duncan**. Thank you, Mr. Chairman.

Mr. Chapoton, would you please comment on the extent to which the Treasury's provisions dealing with deferred expenses may impact on closely held businesses?

Mr. **Chapoton**. Mr. Duncan, I do not see those provisions impacting more on closely held businesses than publicly held businesses, so I guess I do not see any specific impact. As I mentioned in my testimony, there are exceptions. For example, an exception for any sale of $250,000 or less. There are exceptions for sale of farms or real estate by small businesses.

Mr. **Duncan**. How does Treasury treat borrowing stock? I understand that as a person you can loan an individual stock. Whoever has the lower income, he can sell it, and if he is in bankruptcy, then a lender can take a loss on his stock?

Mr. **Chapoton**. I did not understand.

Mr. **Duncan**. On borrowed securities.

Mr. **Chapoton**. On borrowed securities?

Mr. **Duncan**. Yes; say I loan someone 100 shares of X stock, and he sells it. He is in a lower income bracket. And then he bankrupts and does not pay me back. Can I take that as a loss?

Mr. **Chapoton**. Yes, you can take the loss on that. You have loaned him that. He has an obligation to you, and he defaults on that obligation, and you have no ability to collect. You clearly can take a deduction on that.

Mr. **Duncan**. Well, would there be some abuse in transferring or loaning stock to a person of lower income, say a family member or something?

Mr. **Chapoton**. If it is a bona fide transfer, there is no problem. The cases we deal with are the interest-free loan to a family member, and yes, we would—these proposals would impute interest on that transaction from the borrower to the lender.

Mr. **Duncan**. Thank you very much, and thank you, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Dorgan will inquire.

Mr. **Dorgan**. Thank you, Mr. Chairman.

Mr. Secretary, this is a very interesting subject, and I would like to follow up on the discussion you had with Mr. Downey. The issue is abusive tax shelters; but I would like to discuss tax shelters generally.

If you assume Government has to raise a certain amount of money, then for everyone who is enjoying a tax shelter, it is kind of like a balloon. If you squeeze it in one place, it pops up in another. For everyone who enjoys a tax shelter, someone else pays higher taxes.

And in this town I have discovered that for every line in the Tax Code and every line in the appropriations bills, whether it is wasteful or bizarre or useful or good, there is a constituency for it, and in most cases a strong contituency. And tax shelters have simply exploded on us in recent years.

Mr. Downey asked you a question, and I was a little surprised by your answer. In 1981, Dale Jorgenson of Harvard testified before this committee, and he said if ACRS were enacted, tax shelters would need their own line on the GNP accounts. He was predicting an absolute explosion in the use of tax shelters, not just abusive, but all tax shelters. Mr. Downey asked you whether the 1981 bill and ACRS which was enacted by Congress did not promote the explosion of tax shelters, and you sort of hedged on that. In fact, you suggested probably not.

Mr. CHAPOTON. No, I would not say that ACRS has caused the explosion of tax shelters.

Mr. DORGAN. What is causing the explosion of tax shelters?

Mr. CHAPOTON. I think it is very difficult to say. I think we saw the real explosion of tax shelters occur in the late seventies. Clearly, ACRS deductions, because they are generous, do give rise to tax shelter possibilities, particularly, for example, in real estate transactions, but real estate transactions have been used in tax shelters for more than a decade or two, so I think you just cannot attribute it to that factor.

Mr. DORGAN. But I don't think the facts would support a contention that the explosion or growth of tax shelters occurred in the late seventies. There certainly was growth in the late seventies, but I think the Internal Revenue Service would tell you that from 1981 forward we have seen an incredible frenzy of tax shelter activity. I think the facts support the contention that the 1981 Tax Act has given rise to incredible new activity in tax shelters. Do you disagree with that?

Mr. CHAPOTON. I would disagree with that, but I would be happy to look at those figures. We have to recognize that one of the problems in tax shelters, in the number of cases in the courts, I am sure most of those cases arose before 1981, for example.

Mr. DORGAN. Or the number of tax shelters that the IRS wants to investigate. That has risen exponentially in recent years.

Mr. CHAPOTON. So many of the tax shelters that the IRS is concerned about involve debt problems. If it is a straight tax shelter, not involving a leverage device, not involving some abuse in valuation, then it is simply not a concern to the IRS.

Mr. DORGAN. If you have an ACRS that is overly generous, that is, that allows assets to be written off more rapidly than they should, and you say that, and I contend that tax shelters result from that, the growth of tax shelters results from that, and you say there are abusive tax shelters, some of which might result from ACRS.

If you attempt to strengthen the trap in order to catch those abusive shelters, but do nothing about removing the bait, will you ever solve the tax shelter problem?

Mr. CHAPOTON. You have to recognize that if you have a tax shelter that simply buys property and takes ACRS deductions and investment tax credits without a leveraging device, without a mismatching of income, without using the time value issues that we are addressing, no one, I think, would call that an abusive tax shelter, even though the ACRS deductions are beneficial. So you could not say it gives rise to abusive tax shelters, because that is the type of tax shelter that would give IRS no trouble.

There have to be other factors that cause it. Now, true, when you give greater deductions, you are going to have more interest in tax shelter activity, so I am not disagreeing that greater deduction for capital cost recovery heightened interest in, in fact, transferring tax benefits, which is what a tax shelter does.

Mr. DORGAN. A tax shelter is the method by which the Federal Government collects less money than it otherwise would. It is like the drain in the bathtub. And as a former tax administrator myself, I think we probably could not by design sit down and create the grotesque distorted tax system we now have. I am not sure anybody could imagine that kind of a system, and I sense real storm clouds over this system.

I mean, I am talking about people out in the country who do not have tax shelters, do not make enough money to worry about tax shelters, but who we rely on in this country to pay a substantial portion of the tax revenue, who are becoming very upset and very angry about the inequities, most of which are caused by tax shelters in our Tax Code.

Mr. CHAPOTON. I do not disagree with much of that, Mr. Dorgan. I would simply point out that if it is a tax shelter that is not abusive and you and I could discuss some time what is abusive or not, the marketplace adjusts the rate of return so that if you invest in a piece of equipment and get an ACRS, other people can invest in that same piece of equipment and get the ACRS benefits. The rate of return we are going to get out of that transaction is adjusted accordingly.

So I agree with your concern about possible perception impact, but economically I do not see a problem once you decide to give a deduction of that magnitude for investment, which we decided, this committee and we decided in 1981 that much faster writeoff should be given for investment.

Mr. DORGAN. My point is that is a method that this Congress uses to forego revenue, which is about the same as spending, and the difficulty is on this committee, once we do that, we do not review it every year as we would if we were spending it in the Appropriations Committee.

Each year the Appropriations Committee would have to review it and determine whether or not you want to spend it again. But when you put ACRS, as we did in 1981, into the code, we do not then go back in 1983 or 1985 or 1988 and review it.

In fact, it is extraordinarily difficult to get something like that out of the code. I do not want to suggest that every tax shelter is wrong or every tax shelter is abusive. I am just suggesting that out there in the country a lot of people do not have the opportunity or interest to deal with tax shelters, and they pay a lot of our taxes in this country, and they are very concerned about this whole system.

And I think what you are doing today is sort of cranking some of the small screws and some of the small bolts, but really not addressing the major difficulties in our tax system.

Mr. CHAPOTON. But we should, and we are studying the broader picture. We agree with you on that. I would think I would certainly echo your point that I do not want you to think by our position that all tax shelters are abusive. I think we ought to stay away from that charge, because that is simply not the case. It gives certain benefits in the Tax Code. Whether you and I would always agree a particular benefit is justified, it is in the law, and the investor can take advantage of that and shelter unrelated income. It is not necessarily abusive.

Mr. **Dorgan**. No one has made the charge they are all abusive. I make the case that they are very expensive.

Chairman **Rostenkowski**. Mr. Matsui will inquire.

Mr. **Matsui**. Thank you, Mr. Chairman.

There are so many different areas in this, Mr. Chapoton, that it is difficult to really frame the proper question, but I would like to talk a little bit about the high value of money section, and in particular the nuclear power plant decommissioning issue. As you know, Mr. Gibbons has introduced legislation dealing with that particular problem, and it seems from at least the report and also your comments that you are obviously very opposed to that legislation.

Now, if a State public utility commission should grant a passthrough of the cost of decommissioning, so that the consumer ends up paying on a yearly basis or a monthly basis in his or her charges, that is ordinary income to the private utility. Is this correct?

Mr. **Chapoton**. Yes; right.

Mr. **Matsui**. Now——

Mr. **Chapoton**. Excuse me. If you pass through the benefits of what tax reduction from the earlier deduction?

Mr. **Matsui**. What I am talking about is, let us assume that there will be decommissioning costs some 20 or 30 years down the road.

Mr. **Chapoton**. And you take the deduction now.

Mr. **Matsui**. We are not talking about the deduction, but, in other words, the PUC will pass through the cost of that to the customer, so the customer in his or her monthly bills will be making a payment today for that particular cost.

Mr. **Chapoton**. That is correct.

Mr. **Matsui**. And that is ordinary income to the private utility.

Mr. **Chapoton**. To the utility, yes.

Mr. **Matsui**. OK. If the utility then takes that money and puts it in a fund for the purpose 20 or 30 years down the road of eventually paying the decommissioning costs, are you suggesting that that is not a deductible item to the utility at that time, even though it is ordinary income when it comes in?

Mr. **Chapoton**. Yes; and let me explain. We are suggesting that. I would distinguish two situations. One is where the utility voluntarily sets the money aside and has the money and the income on that money fully to its use.

If it does that, it will have the same economic result if it does not take a deduction now and reports what you would describe as excessive income in the early years, takes a deduction later. It reaches the same economic result. You have to put the pencil to it to see that, but we have done it, and we conclude that the result is the same.

I would draw a distinction, though, between that case and the case where the utility is required under State law to set the amount aside. Then I think it is something we maybe should look at further to see if the required deposit is currently deductible.

Mr. MATSUI. Is your suggestion then liability accrues for the decommissioning costs? Is that right—The latter case you described, if the PUC requires it. In other words, they could get around your rule, then, just by having the PUC declare that the money has to be held. Is that correct?

Mr. CHAPOTON. But only if the funds are put outside the reach of the utility on a day-to-day basis. If they are still the utility's assets, we would not say that it is currently deductible.

Mr. MATSUI. You see, one of the problems with your proposal is that most utilities will not set up a fund if, in fact, they can deduct the money, and you end up making the future consumers pay the cost of decommissioning rather than the present consumers who are actually using the nuclear powerplant. Is that a fair statement?

Mr. CHAPOTON. Well, you know, the treatment of the computation of the charge, current charge to consumers, customers of utilities and the resulting income to stockholders of utilities is a very complicated subject.

For example, it was just pointed out to me that a factor, an asset in that computation that you and I are going through, is the present value of the future benefit of the tax deduction. That would reduce the cost to the present consumer. So frankly, you just have to run the numbers on each of these.

We know one thing is clear, though, that the deduction, if the deduction is not discounted, the present deduction of the future cost is excessive. If you talk about funding it, then, true, you can reap the proper result unquestionably, if you fund an amount.

Mr. MATSUI. You would have no problem then if you discounted the cost and put it in the trust fund. Is that correct? Because then you eliminate the time sensitive part.

Mr. CHAPOTON. Conceptually, we have no problem if you discount the amount. Practically, we have trouble doing that. But if you could work that out, work out those practical problems, we would have no problem with it, but they are significant. For example, if you overestimated the cost, then you would have to have a recapture mechanism later when that amount is not spent, so it raises a lot of practical problems, but no doubt conceptually it is sound.

Mr. MATSUI. Thank you.

Chairman ROSTENKOWSKI. Mr. Moore will inquire.

Mr. Frenzel.

Mr. FRENZEL. Thank you, Mr. Chairman.

Thank you, Mr. Secretary, for your testimony.

In the joint committee pamphlet on page 30 there is a suggestion to treat publicly traded partnerships or partnerships with more than 100 members as corporations. I understand your testimony before the committee of the other body was in opposition. Has Treasury changed its position?

Mr. CHAPOTON. No, sir, we have not. We have opposed treating publicly traded limited partnerships as corporations.

Mr. FRENZEL. Thank you.

Mr. Chairman, I have a list of questions relating to publicly traded partnerships which I would like to make part of the record and have the Secretary respond to at a later time.

Chairman ROSTENKOWSKI. Without objection.

[The questions follow:]

QUESTIONS REGARDING PUBLICLY TRADED PARTNERSHIPS

Question 1. Does Treasury have an estimate of how many existing partnerships there are with more than 100 partners? [If not, would you please supply that for the record].

Question 2. Does Treasury have an estimate of how many existing corporations there are with fewer than 100 shareholders? [If not, would you please supply that figure for the record].

Question 3. Mr. Pearlman, I understand that the stock of over 98% of all U.S. corporations is not listed on any public exchange. Does Treasury have an estimate of the number, as well as the percentage, of corporations the shares of which are so listed? [If not, would you please supply that figure for the record].

Question 4. If all partnerships having more than one hundred partners, or whose units are publicly traded, are treated as partnerships, why doesn't it follow that all corporations having fewer than 100 shareholders, or whose shares are not publicly traded, should be treated as partnerships?

Question 5. In Treasury's view, from a tax policy standpoint, is either the number of partners or the fact that partnership interests are publicly traded by itself a satisfactory criterion for distinguishing between a partnership and an association taxable as a corporation?

Question 6. To the extent that large partnerships might previously have created an audit problem for IRS, hasn't that problem been eliminated or substantially reduced as a result of the partnership level audit provisions contained in TEFRA?

Question 7. Mr. Pearlman, I understand you testified before the Senate Finance Committee that taxing partnerships as corporations could have an adverse effect on capital formation in the case of natural resource exploration, research and experimentation and housing development, for all of which industries Congress has long provided major tax incentives and all of which heavily utilize the partnership form of doing business. Do you see any rational reason to exclude investors from this treatment only because they are partners in large partnerships that presumably are more efficient and spread risk more effectively for small investors than small partnerships?

Mr. FRENZEL. Mr. Secretary, what bothers me about this list of items is that you can point out what is to you an abuse in each one, and we might all or most of us agree with you on it. We do not know what other things happen to people who may have been using these sections of the code for quite reasonable purposes.

And one of those things that bothers me is the question of multiple trusts, where you have come out second in a number of lawsuits, and apparently seek to reverse the effect of those suits, and at least the language in the joint committee print is sufficiently vague, and we will never see the legislative language until the day we mark up.

We are going to have to have an idea of what we are really talking about. You know, there are different kinds of cases which involve different kinds of trusts, from a case like, I guess, the Morris case, where they involved almost identical trusts. How the heck are you going to write that up? What distinctions are you going to make?

Mr. CHAPOTON. Well, Mr. Frenzel, first of all, we are not making proposals on combatting multiple trusts in our budget. It is listed in the committee pamphlet, and it is an item that the staff has asked and we are now reviewing, and it is an item, frankly, that we think is of concern, but the very problems you raise are the ones that we are looking at.

This problem has been addressed in prior years, but never quite addressed successfully, and we all could describe a case we think should not be allowed to exist, the same beneficiary, same grantor, 10 trusts. We all would say you ought to put those 10 trusts into 1.

Mr. **Frenzel**. Well, would you give for the record at some point a little guidance to the committee? Because obviously we are going to have to make a decision on this.

Mr. **Chapoton**. We will do that. We have been studying this, and frankly, I think we would support some rules. In other words, we had regulations issued, I believe, in 1972 which were held invalid in that case, and we certainly support those regulations, so we would support a limitation in this area, but the problems you raise are the very problems we would have to deal with.

Mr. **Frenzel**. The regs are not terribly definitive or precise. The word "substantially" appears again and again and again, and what is substantial to you may not be substantial to me or some other taxpayer. That is the problem with it. Go ahead.

Mr. **Chapoton**. I just think sometimes in areas such as this, Mr. Frenzel, when we try to become so specific, we probably lose the battle. I am not sure that a little vagueness, if you will, is not proper when we are dealing on the outer limit of an area which simply involves tax avoidance and has no purpose beyond tax avoidance.

Mr. **Frenzel**. Well, OK, but your definition of what is no purpose other than tax avoidance might be different for other people.

Mr. **Chapoton**. The tax savings, I would put it.

Mr. **Frenzel**. On page 7 of your testimony you deal with section 483 in which you say we have to curb abuses with respect to two payment installment sales. Again, how broad a solution are you looking for? How about a five-payment, 10-year arrangement?

Mr. **Chapoton**. The problem would disappear altogether under our proposal because the interest would be allocated to each payment on an economically sound basis. That is the rule today.

Mr. **Frenzel**. What is an economically sound basis?

Mr. **Chapoton**. You recalculate the interest as though parties had agreed to an interest rate equal to the rate they in fact have agreed to, and then you allocate that on a compound basis to the particular payments. It would take, frankly, a table to do it, but it is clearly required.

Mr. **Frenzel**. Well, would that require the Treasury to publish a table as a part of its regulations?

Mr. **Chapoton**. Yes.

Mr. **Frenzel**. And so until you got that published, we would all be operating in the dark?

Mr. **Chapoton**. No, no. We can publish the table quite quickly. We could even put it in the committee reports, because it is a mathematical calculation.

Mr. **Frenzel**. So you would recommend that it be in the committee report?

Mr. **Chapoton**. We do not normally do that, but I would not have any concern about that.

Mr. FRENZEL. Or that at least such a table would be describe in the committee report?

Mr. CHAPOTON. Yes, or we could agree to issue the table on date of enactment if you wish.

Mr. FRENZEL. OK. I would like to see such a table, or at least be informed of what the mathematical basis is.

My time has expired.

Chairman ROSTENKOWSKI. Mr. Gibbons will inquire.

Mr. GIBBONS. Mr. Chapoton, I may go back over some of the old ground with you. First of all, let me congratulate you and the administration for attempting to do something in a very tough area. I realize it is extremely tough in just reading your statement and listening to you give it. I realize we have a lot to learn in this area. I am talking particularly about myself.

Let me talk about two things. One, apparently you are shooting down the so-called builder bonds. Is that right?

Mr. CHAPOTON. Mr. Gibbons, that is a difficult area. In our proposal on trusts for investments in mortgages, our TIMS proposal, which is in the budget, and which legislation we have not sent forward, the builder's bond question is raised tangentially because we are attempting to say that once the TIMS legislation is in effect, that that is the only game in town, if you will, with respect to mortgage passthrough offerings.

Some builder's bonds arrangements have the same effect. We would prefer, however, to deal with the builder's bond question, which is basically an installment sale question, that is, whether a party who has made installment sales of homes on which it holds the mortgages can then cash out and in effect walk away from the mortgages without paying tax liability.

We would prefer to deal with that separately from the TIMS proposal, and therefore we are attempting to minimize to every extent possible the impact on builder's bonds from the TIMS proposal. We may be back to the committee, though, with a 453 proposal.

Mr. GIBBONS. If you were changing 453, you would look at the whole matter of installment sales. Is that correct?

Mr. CHAPOTON. That is correct. It would not be limited to mortgages, either.

Mr. GIBBONS. Now, let me go back to the bill that Mr. Conable and some of us have introduced about the decommissioning of atomic plants, and let me tell you, I realize you have had a dialogue with Mr. Matsui, but unfortunately I was not able to hear it all, and perhaps some of this is going back over the same ground.

Over the years, as I grow older—I am 64 now—I have sort of come to the conclusion that perhaps we have been pushing off too much of current expenses over to future generations. I realize all people my age do not necessarily take that view.

And what I have been trying to do in my own philosophy, in my own public policy decisions, is to try to figure out, you know, what are the things that we are doing today that we should be paying for today, and what we should not legitimately push off to somebody in the future.

I see us pushing a big national debt. I see us pushing a lot of other deferred things, like deferred compensation, pension, retirement plans, and everything else onto future generations that are not going to be able to carry their own expenses and all these things, too, as I see it.

So, it is in that light that I introduced the atomic plant retirement program, and you know, it probably needs some fixing or some tinkering. There is nothing sacred about the way I have attacked it, but I think as a matter of public policy the people who are using the plant should be the ones to pay for the decommissioning of it rather than the people who get no use out of the plant at all, which is some future generation.

Now, as I understood what you said basically here, you are not going to allow any setting aside of funds or decommissioning-type proposals until the actual decommissioning starts, and as a matter of public policy, that seems to me to be transferring the cost to someone who gets no value out of the use of the plant.

A decommissioned plant is of no value to an electric utility, an electric current purchaser if the plant is decommissioned. It is those people who use the plant during that 40-year period who should be paying for the decommissioning of it.

Now, having expressed my philosophy, I would like to hear from you about it.

Mr. CHAPOTON. Well, Mr. Gibbons, I agree completely with what you are saying. The people who are using the plant now ought to pay the cost of decommissioning. Our only point is, they should not be allowed a tax deduction in excess of that cost.

Mr. GIBBONS. In excess of that cost?

Mr. CHAPOTON. Right. Now, that means conceptually, theoretically, you would allow a tax deduction for the present value of that future cost, and if we could work that out, we will be happy to agree with you on that.

Mr. GIBBONS. Well, that sounds fair. That sounds fair. You know, any suggestions you have to improve the bill that we have, I would like to work with you on them.

Mr. CHAPOTON. OK.

Mr. GIBBONS. It is a different situation than most of the tax shelters that I see you describing.

Mr. CHAPOTON. Absolutely. It is a different situation, and it is a problem, and certainly no one would argue with the fact that the present users ought to bear that future cost, and that is clear.

Mr. GIBBONS. All right, fine. Thank you, sir.

Chairman ROSTENKOWSKI. Mr. Jenkins will inquire.

Mr. JENKINS. Thank you, Mr. Chairman.

Thank you, Mr. Chapoton. I want to ask for clarification on two points. In your interest-free loan section, you indicate on page 15 that care has been taken to prevent these new rules from applying to common family loan situations not involving tax avoidance. I want to make sure that I understand what those exceptions that you have carved out would really do to the common, no interest family loan, situation.

You indicate that if the borrower has passive income of $1,000 or less, there would be no problem.

Mr. CHAPOTON. Mr. Jenkins, let me first point out that there is a $10,000 exception. That is, a loan of $10,000 per borrower is not affected.

Mr. **Jenkins**. I understand that. But let me give you an example. If a child has some property of his or her own that brings in dividends of a couple of thousand dollars a year but a parent wants to loan that child $50,000 at one time for a home or for a business or whatever, interest-free or at a low rate of interest, how would that transaction be affected?

Mr. **Chapoton**. It would affect the transaction if he has more than $1,000 of passive income. The result simply would be that you would attribute—you would impute interest on the amount in excess of the loan required to earn more than the first $1,000. The first $1,000 would be free, and the amount in excess of that would give rise to imputed interest back to the parent.

Mr. **Jenkins**. So in effect you would discourage one from making a low-interest rate loan.

Mr. **Chapoton**. If there were outside income. That is correct. Significant outside passive income.

Mr. **Jenkins**. $1,000 is not significant, is it? One could have $7,000 drawing a reasonable rate of interest and you would get to your $1,000 cutoff.

Mr. **Chapoton**. Mr. Jenkins, actually, I do not think we ought to focus too much on the level we pick. The whole purpose is to avoid shifting of the income, and we are all trying to make an exception for the nonavoidance transaction, purchase of a home, but at some level you have to say that where the child has outside income, the effect of the transaction is to transfer that income to a lower bracket by the low interest or interest-free loan.

So you can pick whatever number you think is appropriate, but you have to recognize that is the effect of it, and that is the purpose of our proposal. Now, in every case I think we would agree where the stated purpose is, and you can trace the funds into investment, then that is a different case, and I know you are not addressing that case, but in that case, that case in no event do we say has the effect of bypassing these rules.

Mr. **Jenkins**. My concern is not with the abuse that you are trying to address. I am concerned about the reasonable exception that ought to be made for a family loan, low interest rate loan, or no interest rate loan.

Mr. **Chapoton**. Mr. Jenkins, I misspoke, and that in our proposal the $1,000 was a cliff. I said you would impute over $1,000. Under our present proposal, if the child has more than $1,000 of passive income, then the rules fully apply to the loan, so that interest would be imputed.

Mr. **Jenkins**. Now, that is even more restrictive.

Mr. **Chapoton**. It is more restrictive. It is also more administerable. You can always look at what the level of passive income is you want to deal with, but it simply says the rules apply if he has more than *x* amount of passive income.

Mr. **Jenkins**. If the borrower has more than $1,000 of passive income, you cannot make an interest-free loan without imputing interest. Is that right?

Mr. **Chapoton**. That is correct. You can make it, but the tax effect is not avoided. The tax benefit from the interest-free loan is not achieved.

Mr. JENKINS. My time is about up. Let me ask one other question on the prepayment of expenses. I understand what the administration is attempting to address here, but really as a matter of policy is there any difference between permitting the prepayment of expenses and permitting the 15-year depreciation on a building that has a life of 40 years? You permit an advanced writeoff for real estate. What is the real difference from the policy standpoint?

Mr. CHAPOTON. I think a major difference is that in the specific writeoff of a building or a piece of equipment, the Congress has decided that indeed a deduction should be accelerated, and you are suggesting and I would agree that the deduction is faster than economic depreciation, so you are giving a benefit for investment and incentive for investment in that piece of equipment, because you are lowering the tax rate on that piece of equipment.

Where there is no such policy objective, the prepayment simply is a device to shift income from this year into the next year, and then the following year you must do the same thing, and that is indeed what happens.

Mr. JENKINS. So in order to shelter or manipulate income, you are forced to go to capital items. There is no real difference.

Mr. CHAPOTON. But the point is that you have a set of depreciation rules, ITC rules that give a specific incentive to income. If you can combine that investment with manipulation of related expenses, for example, expenses in managing that piece of property, then you not only get the benefits of the ACRS deductions, but you accelerate the management expenses as well.

Mr. JENKINS. But suppose you have no ACRS property and you are dealing in inventory or whatever it may be——

Mr. CHAPOTON. I cannot think of circumstances where we are talking about normal inventory of property. The rule we are talking about simply applies to tax shelter arrangements; it does not apply to cases, for example, where the parties are in active business. It simply is aimed at tax shelter manipulation for accelerating deductions.

Mr. JENKINS. My time is up.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Are there further questions?

Mr. FRENZEL. Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Gibbons will inquire, then Mr. Frenzel.

Mr. GIBBONS. Mr. Chapoton, I hate to bring this up. Yesterday I was getting on the airplane, and I started getting nailed by people in the line about your ruling of February 10, or your press release on arrangements dealing with reduced employee taxable income in the cafeteria plans. Would you like to tell me what you have done, and tell me some of the problems you have run into, so I can be in a better position to answer questions from constituents?

Mr. CHAPOTON. Well, the basic case that is of concern to the Internal Revenue Service and to us is the case—the most egregious case is the circumstance where at the end of the year the employer writes a notice to its employees and says, if you have had any expenses in the following categories—the most predominant ones, I guess, would be medical expenses or child care expenses—then if you will give us the amounts involved, we will act like we reimbursed you for that expense. Your check will not change, but we will act like we reimbursed you for the expense, and we will reduce your taxable income on your W-2 by the amount of that expense.

Mr. GIBBONS. That sounds like fraud.

Mr. CHAPOTON. Well, the position has been taken——

Mr. GIBBONS. They really do things like that?

Mr. CHAPOTON. Yes, sir. We can show you a notice to employees.

Mr. GIBBONS. Well, you ought to put them in jail. You mean, you write all your employees and say, well, if you had any medical expense or anything that fit in this category, just tell us, and we will act like we paid you that?

Mr. CHAPOTON. That is correct. The expenses are paid.

Mr. GIBBONS. Well, I think if I did that you would put me in jail.

Mr. CHAPOTON. I think we would agree that that situation comes close.

Mr. GIBBONS. Now, is that what people are complaining about?

Mr. CHAPOTON. No, there are other situations that have the same economic effect.

Mr. GIBBONS. There must be somebody out there who is interested in the subject.

Mr. CHAPOTON. Well, there is a good deal of interest in the subject. The other extreme, and which is clearly permitted, is the case where at January 1 the employer says, all right, I am going to institute a cafeteria plan, and you can elect to reduce your salary by $5,000 this year and if you elect that then I will pay all of your medical costs incurred this year. That is OK. It is not OK if the employer says, and by the way, if you only incur $4,000 of medical costs, I will give you the extra $1,000 at the end of the year, so that I am not really bearing any cost.

Mr. GIBBONS. Yes.

Mr. CHAPOTON. So where the transfer of the risk of the medical cost to the employer, and the benefit that it might not be that much, clearly that is a valid cafeteria plan. So those are the two extremes. The announcement says that the case I just described, the first case, is bad, and any other case which has the effect of not shifting the liability, the risk of the payment to the employer, and people did, because there were not clear rules outstanding on this, people did adopt what might be called very aggressive cafeteria plans. This rule says those did not work.

Mr. GIBBONS. So ones where there was a clear reduction of salary in advance, those are all right. Is that right?

Mr. CHAPOTON. That is correct, as long as it was not I think what they refer to as a zero plan that would make up the difference so that you could not lose.

Mr. GIBBONS. I can understand that, yes.

Mr. CHAPOTON. You would get the full amount.

Mr. GIBBONS. That is just like the other example you gave me of at the end coming and saying, well, what did you spend, and I will pretend I paid it for you, and you can reduce your taxable income by that much. How did we ever get in this ridiculous position anyway?

Mr. CHAPOTON. In 1978, the Congress adopted rules permitting cafeteria plans; that is, saying that the mere fact that you can elect between the first of the year or before the expense is incurred, the fact that you can elect to receive that rather than cash does not cause you to be taxable under the constructive receipt doctrine. Normally under that rule if you come to a year and you say I am going to turn my back on cash and I want this tax-free benefit, you would not be able to turn your back on the cash.

Mr. GIBBONS. Did we limit what you could put in this cafeteria?

Mr. CHAPOTON. No, it is not limited at all. We have suggested, as a matter of fact, that——

Mr. GIBBONS. Could I put my housing in a cafeteria plan, or something like that?

Mr. CHAPOTON. Excuse me. We did limit it——

Mr. GIBBONS. Not that I am going to do it; I am just asking you if I could do it under this ridiculous——

Mr. CHAPOTON. We did limit it in some respects to statutory fringe benefits that could be included. Our concern has been that nonstatutory benefits such as parking or items that we may think clearly are taxable and that the employer would agree are taxable are included in a cafeteria plan. We are proposing amendments to the cafeteria plan, rules that would say only benefits that are statutorily exempt from taxation can be included.

Mr. GIBBONS. All right. Well, thank you very much. It will help me answer a lot of my mail.

Chairman ROSTENKOWSKI. Mr. Frenzel will inquire.

Mr. FRENZEL. Thank you, Mr. Chairman.

Buck, last time we had some time here, I asked you about 483, and in the only figures that I have available to me 483 revenue increases and original issue discount increases are lumped together to be about $3 billion. That is about 25 percent of the total revenue increases contemplated, I think, over a 3-year period.

Could you separate out the 483 from the original issue discount? It strikes me that 483 is going to develop the lion's share of that, and I would like to know what that number is. You do not have to have it today, but whenever you have it.

Mr. CHAPOTON. We can split those numbers out. Yes, sir.

Mr. FRENZEL. Thank you very much.

Mr. GIBBONS [presiding]. Are there further questions? Mr. Dorgan?

Mr. DORGAN. Thank you, Mr. Chairman.

I am interested in the time value of money issue with respect to discussions you have had with other members of the committee. I do not know whether you have talked specifically about strip mine reclamation, but in an example where strip mining operations are commencing and the State law would require there to be money set aside for reclamation of strip mined land, what you are saying is that at the time that the expense is accrued, as the law requires, you will not allow the operator to deduct that from their income tax in that year because of the time value of money problem.

When reclamation follows strip mining by probably 2 or 3 years, 4 years, perhaps, no more than that, is that a major problem, time value of money problem?

Mr. CHAPOTON. You would be surprised how when you discount it at a healthy rate, how large the difference is. So I think, yes; it is not as major as if it is a long period of time, but I think we look at the idea of having the exception for payments made within a short period of years but then determine that it is a problem.

Mr. DORGAN. How do you answer the person who says, well, I have a small strip-mine operation, or larger, for that matter, and am required by State law to accrue a certain expense that provides for reclamation funds, and you say that I cannot deduct that money.

Mr. CHAPOTON. In your case, is he required to set the funds aside somewhere else?

Mr. DORGAN. Yes; specifically.

Mr. CHAPOTON. I think I would draw a distinction between accrual on its own books and actually payment to another fund that is beyond his control. I would think in the latter case that it is something we could consider further. Where the funds are still within his control, though, I think the principles would be the same as under our proposal.

Mr. DORGAN. Well, I have not looked into this, but my guess is there are shades of differences in States and between operators of what is required, but I know that in our State, where there is a substantial amount of strip mining, we do require a very sophisticated reclamation segregating topsoil, and so on and so forth, and we do require those operators to set aside money for reclamation program, at the time of the mining. I just think that a mine operator might legitimately complain about being required to set aside money but not being able to expense that against current income.

Mr. CHAPOTON. You see, the benefit is, when he actually sets aside the money he is going to set aside a discounted amount. Nobody would set aside $1 million today to pay a $1 million expense in the future. So you do have a constraint built in that the amount set aside is not excessive.

And as I mentioned earlier, you get into some administrative complexity allowing that, but conceptually that is the right result, so we would not have a problem if we could work it out from an administrative standpoint.

Mr. DORGAN. Why do you not look at some time frame? Because in the case of the kind of strip mining that we see, they do not allow an open pit to remain open when that coal seam is exhausted. They require that overburden be replaced and the topsoil to be replaced. So, generally speaking, reclamation follows quite closely the actual mining. I am wondering if you could not consider some kind of timeframe with respect to that deduction.

Mr. CHAPOTON. We can certainly look at that; yes.

Mr. DORGAN. Thank you.

Mr. GIBBONS. Mr. Chapoton, let us go back to the cafeteria plan again. Back when I was chairman of the Oversight Subcommittee during the previous administration, I used to give your predecessor hell about taking so long to get regulations out, and you say Congress passed this cafeteria thing in 1977, and we are just putting out press releases about it today?

Mr. CHAPOTON. That is correct.

Mr. GIBBONS. Could you tell me why it takes so long to do these things? You know, I am not a very good partisan, so I am not jumping on you from a partisan angle. I used to really raise hell with your Democratic predecessor about this. But 1977. This is 1984.

Mr. CHAPOTON. Mr. Gibbons, I think that is a very valid criticism, and I think indeed that is the one point that people make in this entire area dealing with this release that gives their arguments some weight. Because of internal conflicts on what those rules mean, the regulations were delayed for an inexcusable period of time.

We talked about this when we first came. Obviously, this legislation preceded this administration. We have talked about it when we first came into office. But the problems kept putting the regs on the back burner. Suddenly we woke up to the fact that people without guidance—that employers were taking very aggressive positions.

Mr. GIBBONS. Well, do you all keep some kind of a suspense file down there about regs you have not issued, or something like that?

Mr. CHAPOTON. We spend a great deal of time trying to improve the regulation process. We have a backlog of almost 400 regulations right now. Some are quite old. Some are quite recent. It is a tremendous problem. Other than the fact of keeping working on it, we have not found any solution to the problem.

Mr. GIBBONS. Well, is it a shortage of personnel, or what is the problem?

Mr. CHAPOTON. It is to some extent a shortage of personnel. In my office, the tax legislative counsel, which most regulations come through after they are developed at the Internal Revenue Service, we have increased personnel by four people to deal with this problem, but I think there are also a number of other problems. It is getting attention at the top levels when a policy judgment needs to be made before a project can go forward.

Mr. GIBBONS. If you have got to pass on regulations and we keep you down here asking questions like this, it cuts into the time in which you can do your real work, but is there not some way we can find to get both of these things done at the same time?

Mr. CHAPOTON. We have revised the procedures again just recently, for example, in dealing with just that problem. We have decided to keep someone at a high level out of the legislative process so that the policy issues can be addressed as they occur.

But I would just point out to you when we adopt a piece of legislation that has significant questions, many of which are unanswered that need input from outside to determine how you answer the questions, it is a very time-consuming process to deal with those.

We, for example, a year ago called upon the bar association, an interested group, to submit drafts of regulations on specific projects, and that effort is now ongoing, and we are receiving some drafts. Maybe that will speed it up. But we do not have any answers that solve the whole problem.

Mr. GIBBONS. That is kind of like asking the rabbit to watch the cabbage patch, though.

Mr. CHAPOTON. Well, we pointed out in our announcement that it would be disregarded if it is not objective, and I think we can tell that pretty quick.

Mr. GIBBONS. I am not in sympathy with any of these things that flagrantly flout the law, and I want taxpayers to pay the taxes that they owe, but I do have a hard time defending our Government's action, and I am taking some of the blame myself here, where we pass laws and they are vague and not very easy to follow, and then you in your regulatory capacity have trouble getting the regs out, and then we find taxpayers going out on their own. Our rates are so high, it does not pay to be cautious. And then we slap them down.

I have some sympathy for them. I hope there is some way we can find to work this one out. And I hope there is some way we can find to get these regs out on a much more current basis. If you would like to make suggestions to this committee as to how we could do it, we would be most responsive.

Mr. CHAPOTON. All right.

Mr. GIBBONS. Most responsive.

Mr. CHAPOTON. We have made some significant progress over the last year, but it is a heck of a problem. I agree with your statement that there is some sympathy—you can have sympathy for taxpayers, a lot of sympathy for taxpayers that are trying to do transactions without any guidance, and believe me, there are a lot of them out there.

In this cafeteria plan area, as I said, there was not guidance. People could have, through seminars and matters such as that, known when they were on the outer edge. I think most of the advisers who were involved in the cases we have discussed knew they were in an area that was close to the edge, but you still have to recognize that the absence of guidance would embolden them and make them braver in doing it.

Mr. GIBBONS. Well, you know, I do not read these things. I used to read them compulsively years ago, and I do not do it much any more, and I apologize for not doing it, but, you know, the Wall Street Journal and lots of magazines are constantly publishing advertisements about all these tax shelters. At one time I used to write all those people and get them to send me as much free literature as I could get, and I got so many crazy phone calls and things like that from those people that I finally cut that out. I still get a few phone calls from people trying to sell me diamonds and things like that, and all kinds of weirdo arrangements.

Do you all have someone in your shop who follows those things closely? These things are not done in secret. There are people out there merchandising them. Do you have someone down there who just follows them?

Mr. CHAPOTON. We do follow them. I do not know that it is in any efficient or systematic way. We do get a lot of volunteer advice, but by and large when something becomes marketed, we pick it up.

Mr. GIBBONS. Do you pick it up from auditing?

Mr. CHAPOTON. No, no, we pick it up from the publicity, from the newspapers, but that is not to say we do not miss some.

Mr. GIBBONS. Have you ever thought about the idea, of course, that all of that stuff they pay for is tax deductible, too.

Mr. CHAPOTON. That is correct.

Mr. GIBBONS. Have you ever thought about the idea of making it not so attractive for people to be buying all that garbage that is sold out there, like denying a business deduction for it?

Mr. CHAPOTON. You mean for the printing material, the offering material?

Mr. GIBBONS. For the material.

Mr. CHAPOTON. Well, actually, a number of the costs are now capital costs. I think, though, you come again to the extra interest charge for abusive tax shelter. You have to have a precise definition of what you are covering and what you are not, because some of them there should be no objection to. I think the IRS is doing more at the early end of some of these transactions, some of these offerings, and I think that is a healthy development.

Mr. GIBBONS. Mrs. Kennelly wants to inquire. Mrs. Kennelly.

Mrs. KENNELLY. Good to see you again, Mr. Chapoton. I am sorry I was late, but I have a concern with one of the bills before the committee. It is Mr. Stark's H.R. 4702, and my concern deals with the issue of fairness. First a progam is considered all right, a company participates in good faith because it has been approved by the Bureau of Alcohol, Tobacco and Firearms, and then all of a sudden we are going to close it down.

Did you take a position in your testimony on H.R. 4702?

Mr. CHAPOTON. You are talking about the Puerto Rican and Virgin Island redistillation? It is not in our proposal, or not in our testimony. I was asked about earlier. I think, Mrs. Kennelly, clearly that the arrangement will have to stop. The question we are addressing, and I think the question this committee needs to address is over what period of time it should be terminated.

Mrs. KENNELLY. Yes, I have a situation where a company participated in good faith, thought it was a good thing to be involved in, and then all of a sudden we are going to close it down.

Mr. CHAPOTON. Yes. Mr. Stark made a suggestion earlier that there was not complete disclosure. I had heard that suggestion yesterday, but the materials I have seen on it do not bear that out. That would be a relevant question. The materials I have seen indicate there was complete disclosure, and that the Bureau of Alcohol, Tobacco, and Firearms did issue rulings which permitted this to go forward.

That being the case, I think we cannot make a change in any sense retroactive. I think in Puerto Rico, for example, they do have a balanced budget requirement. The funds are committed. Therefore, we have to terminate this over some period of time. The question, though, is how quickly.

Mrs. KENNELLY. So we would be talking about a phaseout or a cap or something of that nature?

Mr. CHAPOTON. I am sorry?

Mrs. KENNELLY. Would we be talking about a phaseout or a cap?

Mr. CHAPOTON. I think we would be talking about a phaseout. I think clearly the arrangement, the redistillation process ought to be terminated at some point. The question is when it is finally terminated completely.

Mrs. KENNELLY. Thank you, Mr. Chapoton.

Mr. GIBBONS. Well, Mr. Chapoton, we want to thank you for your constructive and courteous attention to the problems here.

[The following was subsequently received:]

DEPARTMENT OF THE TREASURY,
Washington, D.C., February 24, 1984.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: Although I limited my February 22 testimony before your Committee to the revenue proposals contained in the Administration's fiscal year 1985 budget, there is an additional proposal regarding the Virgin Islands which I would like to bring to the Committee's attention. This proposal corrects the technical problems in the current U.S.-Virgin Islands income tax relationship which have in some cases created hardships for the Virgin Islands, and in other cases created the potential for significant Federal income tax abuse.

I am enclosing the press release issued by the government of the Virgin Islands, together with a Treasury summary of the proposal. I am also enclosing a copy of my July 12, 1982 testimony before the Subcommittee on Select Revenue Measures of the Ways and Means Committee, which discussed problems in the existing system of Virgin Islands taxation and the need for reform.

I hope that this proposal can be included in draft legislation as the earliest opportunity.

I am sending a similar letter to Robert Dole, Chairman of the Committee on Finance.

Sincerely,

JOHN E. CHAPOTON,
Assistant Secretary (Tax Policy).

[From Office of the Secretary of the Treasury, Feb. 23, 1984]

TAX TREATMENT OF THE VIRGIN ISLANDS

PRESENT LAW

The income tax laws in effect in the United States are also in effect as the local income tax system of the Virgin Islands, except that the Virgin Islands taxes U.S. residents and U.S. corporations as foreign persons. In addition, corporations chartered in the Virgin Islands and individuals resident there do not file a U.S.tax return or pay U.S. tax. Instead, they are required to file a return and pay tax on their worldwide income to the Virgin Islands. The U.S.-Virgin Islands tax relationship imposes harsh tax results on some taxpayers and creates loopholes for others.

PROPOSAL

The proposal removes the principal hardships and potential for Federal income tax avoidance and evasion under current law. Under the proposal:

V.I. corporations which derive income from a U.S. trade or business will file a U.S. tax return and pay U.S. tax (which will be allowed as a credit against V.I. tax);

Residents of the Virgin Islands with U.S. income will pay the same tax as at present, but will be required to file an additional schedule listing their non-V.I. source income.;

Residents of the United States with V.I. source income will allocate their U.S. tax between the United States and the Virgin Islands;

The Virgin Islands will be authorized to issue tax-free industrial development bonds subject to the general limitations in the Internal Revenue Code.

Governor Juan Luis of the Virgin Islands announced his support for this proposal in a February 14, 1984 press release. The proposal is based on negotiations since January 1983 between the Governor and his representatives and the U.S. Treasury Department.

[News Release, St. Thomas, Virgin Islands, Feb. 14, 1984]

GOVERNOR SUPPORTS FEDERAL TAX REFORM MEASURE

Governor Juan Luis has written Assistant Treasury Secretary John "Buck" Chapoton confirming his support of a proposal to reform the Virgin Islands "mirror system" of taxation.

The proposal by the U.S. Treasury Department was a result of discussions between Treasury and the V.I. Government over the past 12 months. It was endorsed last Friday by the Governor's task force on federal tax issues chaired by Counsel to the Governor William Blum.

Governor Luis said that the proposal covers individual and corporate taxation, as well as administrative provisions, and is designed to eliminate mirror system inequities and to improve tax enforcement and collections.

The proposal is also designed to encourage investment in the Territory, according to Governor Luis, because it will create more certainty in interpretation of tax laws relating to business and individuals and because it will authorize the issuance of tax-free industrial development bonds by the Territory for private sector development projects.

The Governor and his representatives have been meeting with the U.S. Treasury Department since January 1983 to develop this type of proposal. The meetings were promoted by two alternative suggestions made at that time by Treasury; to permit the federal government to take over income tax collections in the Territory or to consider the Virgin Islands as a foreign country for tax purposes.

The Chief Executive agreed with his task force recommendation to reject both these alternatives in favor of the mirror system reform approach contained in the proposal.

Blum explained that under the proposal there would be no change in income taxes for V.I. residents who derive all of their income from within the Territory. Residents who have U.S. income would also pay the same tax as at present but they would have to file an additional schedule listing their non-V.I. income. U.S. residents with V.I. income would allocate their tax between the two jurisdictions.

The proposal is expected to have no impact on local or federal revenues, Blum pointed out, but is designed to bring more equity to the mirror system and to improve the enforcement of tax laws.

Because of the 1984 Congressional Session is a short one, the proposal is expected to be drafted soon and added to a package of tax matters that the Treasury Department is planning to send to Congress.

Members of the Governor's tax task force in addition to Blum inlcude, Lt. Governor Julio Brady, Senators Bent Lawaetz, and Adelbert Bryan, Leroy Quinn and Anthony Olive of the V.I. Bureau of Internal Revenue, Henry Wheatley representing deLugo, Finance Commissioner Claude Christian, Budget Director Stephanos O'Reilly, Attorneys Ron Mitchell, James Isherwood and Cary D'Avino, CPA Leonard Chasen, and businesspersons Margaret Croque, Keith O'Neal, James Southerland, Dick Doumeng, Betty Sperber, Ann Abramson, and Avan Cassinelli.

STATEMENT [1] OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY (TAX POLICY), DEPARTMENT OF THE TREASURY

Mr. Chairman and members of the subcommittee, I am pleased to present the views of the Treasury Department on the following tax bills: H.R. 617 and H.R. 2402, both of which deal with the excise tax on fishing tackle and equipment; H.R. 4917, which would expand the provision of the Internal Revenue Code permitting tax exempt financing for facilities for the local furnishing of gas; and H.R. 6218, which would provide tax exempt status to certain insurance organizations for veterans.

I will discuss each of the bills in turn.

H.R. 5985—CHANGES RELATING TO TAXES PAID TO THE VIRGIN ISLANDS

Background

H.R. 5985, and the position of the Treasury Department on the bill, must be understood in the concept of the particular system of taxation presently in effect in the Virgin Islands. While Treasury fully supports the broader objectives of the bill, particularly the goal of attracting investment to the Islands, we view with great concern the existing and potential tax abuses which result from the interaction of the "mirror code" system of taxation in the Virgin Islands and the U.S. Internal Revenue Code (the "Code"). The hallmark of the present Virgin Islands tax system is uncertainty—which operates to the detriment of both the Virgin Islands and taxpayers with legitimate business interests, and benefits the unscrupulous. For reasons I will describe, we are reluctant to endorse piecemeal amendments to the present Virgin Islands tax system if such changes will increase potential tax abuse or delay comprehensive reform of the "mirror code" tax relationship.

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[1] Time considerations have not permitted the Office of Management and Budget to advise on the relationship of this statement to the program of the President.

The Treasury Department is opposed to the provisions of H.R. 5985 which would reduce the 30 percent Virgin Islands tax on payments of Virgin Islands source dividends, interest and other fixed or determinable income to persons not resident in the Virgin Islands or the United States, and which would allow a taxpayer to elect to take a foreign tax credit for certain Virgin Islands taxes under a relaxed foreign tax credit limitation provision. Despite grave concern regarding any reduction in the Virgin Islands tax on dividends, interest and other fixed or determinable income, which I will discuss, the Treasury Department would be prepared to support a reduction in the Virgin Islands tax on such payments solely to U.S persons.

In my testimony today I will briefly outline the Virgin Islands "mirror code" system of taxation and describe only some of the issues of its interpretation and application which face tax administrators and alternately enrage and enrich taxpayers. After describing the present regimen of Virgin Islands taxation, I will describe H.R. 5985 and explain in greater detail Treasury's position with respect to that legislation.

The income tax laws in force in the United States have, since 1922, been in force as the territorial income tax of the Virgin Islands. Congress established this tax system by the addition of a one-sentence rider to the Naval Appropriations Act of 1922, the precise intent of which is less than obvious. Administrative and judical decisions have interpreted the provision to require the Code to be adapted for application in the Virgin Islands by substituting the name "Virgin Islands" for the name "United States," and vice versa, where appropriate to give the law proper effect. The result is referred to as the Virgin Islands "mirror code."

The question of whether a particular Code provision should be "mirrored" is, in many instances, not evident. Judicial decisions have charted an uneven path, "mirroring" some Code provisions and not "mirroring" others, in each case guided by their interpretations of Congressional intent underlying a provision for which there is little legislative history. I will provide specific examples of interpretative ambiguities under the "mirror code" later in my testimony.

A principal consequence of the mirror code is that U.S. individuals and corporations that are not "inhabitants" of the Virgin Islands are considered nonresident aliens and foreign corporations, respectively, for purposes of Virgin Islands taxation and are subject to the Code regimen of taxation relating to such types of persons.

The Code imposes a different regimen of taxation with respect to U.S. persons, i.e., citizens, residents and domestic corporations, and foreign persons, i.e., nonresident aliens and foreign corporations. In general, the former are subject to U.S. taxation on their worldwide income while the latter are subject to U.S. taxation on a more limited basis. More specifically, foreign persons are subject to U.S. taxation on a gross basis (without deductions) on fixed or determinable annual or periodical gains, profits and income ("fixed or determinable income"), e.g., dividends, interest, rents and royalties, from U.S. sources at a rate of 30 percent and on a net basis (net of deductions) on income effectively connected with the conduct of a U.S. trade or business at a rate and in a manner comparable to that of a U.S. person. These regimens of taxation may be modified by the application of a bilateral income tax convention. When these provisions are "mirrored," U.S. person not resident in or "inhabitants" of the Virgin Islands are subject to a Virgin Islands tax on a gross basis at a rate of 30 percent on fixed or determinable income from Virgin Islands sources and on a net basis with respect to income effectively connected with the conduct of a Virgin Islands trade or business.

In 1954, Congress enacted section 28(a) of the Revised Organic Act of 1954 in order to allocate taxing responsibilities with respect to persons who were "inhabitants" of the Virgin Islands and to transfer additional revenues to the Virgin Islands. Section 28(a) provides that "inhabitants" of the Virgin Islands "shall satisfy their income tax obligations under the taxing laws of the United States by paying their tax on income from all sources both within and without the Virgin Islands into the Treasury of he Virgin Islands." "Inhabitants" of the Virgin Islands include U.S. citizens who are resident in the Virgin Islands as of the last day of their taxable year, corporations chartered in the Virgin Islands, and certain U.S. corporations which operate primarily in the Virgin Islands. In other words, Virgin Islands "inhabitants" are treated as domestic persons, i.e., Virgin Islands persons, for purposes of the Virgin Islands mirror code and pay no tax to the United States, even on U.S. source income.

Section 934(a), added to the Code in 1960, prohibits the Virgin Islands from granting relief, directly or indirectly, from Virgin Islands tax under the mirror code.

However, an exception is made under section 934(b) with respect to non-U.S. source income of U.S. or Virgin Islands corporations that have derived at least 80 percent of their gross income from Virgin Islands sources and at least 50 percent of their gross income from the active conduct of a trade or business in the Virgin Islands during the preceding three taxable years. The Virgin Islands has established an industrial incentive program which provides tax rebates for "934(b)" corporations which meet certain additional investment and employment criteria. A second exception allows Virgin Islands tax relief in respect of a mirror code tax liability of a U.S. citizen who is a bona fide resident of the Virgin Islands for the entire taxable year, to the extent the tax liability is attributable to Virgin Islands source income. These reductions do not operate, however, to reduce Virgin Islands taxes on payments of fixed or determinable income to U.S. or foreign persons. Such taxes generally cannot presently be forgiven under section 934, since the tax (usually collected through withholding at the source) is upon the recipient and not upon the company operating in the Virgin Islands.

For purposes of U.S. taxation, Virgin Islands income taxes paid by U.S. citizens, residents and corporations are creditable against U.S. tax under the foreign tax credit provisions of the Code. In addition, a so-called "deemed-paid" foreign tax credit is allowed upon the distribution of a dividend to a U.S. corporation that owns at least 10 percent of the voting stock of the payor foreign corporation, including a Virgin Islands corporation, with respect to a proportionate amount of the foreign taxes, including Virgin Islands taxes, paid by the foreign corporation on or with respect to the accumulated profits from which the dividend is paid. The amount of taxes which are creditable in any taxable year is subject to the overall foreign tax credit limitation at section 904. The amount of Virgin Islands and other foreign taxes which are allowed as a credit in a taxable year equals the lesser of the foreign taxes paid or the portion of the taxpayer's tentative U.S. tax, calculated before applying the foreign tax credit, which the taxpayer's foreign source taxable income (including Virgin Islands source taxable income) for the taxable year bears to the taxpayer's total taxable income for the taxable year. Excess foreign taxes may be carried back two years and carried forward five years.

The interaction of the Revised Organic Act and the Virgin Islands mirror code with the U.S. Internal Revenue Code gives rise to innumerable problems of interpretative ambiguity and potential tax abuse. One example which is familiar to this Committee involved the use of a Virgin Islands corporation by a foreign person as a vehicle to acquire and dispose of U.S. real estate in a manner which avoided taxation under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"). This abuse was eliminated by section 831(a) of the Economic Recovery Tax Act of 1981. The experience with FIRPTA highlights the potential for manipulation of the Virgin Islands mirror code and Revised Organic Act for tax avoidance purposes. Many other problem areas, uncovered by the Treasury Department or raised in inquiries by taxpayers, remain. The following are examples.

A strict "mirroring" of the Code would permit a Virgin Islands subsidiary to claim a tax credit against Virgin Islands tax for income taxes paid to State and local governments in the United States. While it is not appropriate to mirror Code section 901 in this fashion, corporations, whether foreign or U.S., could seize upon such an ambiguity and establish Virgin Islands subsidiaries to conduct operations in the fifty States for the purpose of claiming a credit for State income taxes against Virgin Islands tax under the mirror code. To the extent that corporations would not incorporate in the Virgin Islands absent such a tax benefit the Virgin Islands might not have an incentive to contest such an interpretation.

The mirror system gives rise to potential tax abuse by individuals, as well as corporations. For example, a correspondent has raised in a letter the issue of whether interest on U.S. Treasury bonds is taxable to a Virgin Islands resident. It has been suggested that section 742 of Title 31 of the United States Code, which provides that obligations of the United States shall be exempt from taxation by, or under, State or local authority, operates to exempt such income from Virgin Islands taxation (and the Revised Organic Act precludes U.S. Federal income taxation). Section 742 of Title 31 is not applicable, however, because the Virgin Islands territorial tax is imposed under Federal authority, that is, the Naval Appropriations Act of 1922. It has been alternatively suggested that a strict mirroring of Code section 103(a) would require that "gross income" not include interest on an obligation of the United States. Such a mirroring would be utterly inappropriate. In light of the state of the law, however, it is not surprising that a hopeful taxpayer raised the issue.

The Treasury Department is convinced that comprehensive legislative reform is needed to remedy the technical difficulties in the Virgin Islands mirror code and the Revised Organic Act. Absent legislative reform, the Treasury Department will be required to take administrative actions, including the issuance of revenue rulings, to deal with these technical issues. Because the potential rewards may be great, taxpayers may, in some cases, continue to adopt interpretations of the law which, though barely colorable, could not have been the intent of Congress. The consequence would be that uncertainty would remain. Illustrative of this problem is the continuing controversy, despite the issuance of new administrative guidelines by the Treasury Department, regarding the obligation of Virgin Islands persons to withhold the 30 percent tax on payments of fixed or determinable income to persons who are not resident in the Virgin Islands. The perpetuation of uncertainty frustrates attraction of the legitimate, stable business investment that the Virgin Islands requires.

The Treasury Department has studied the problems of the Virgin Islands tax system at length and is prepared to work with Representative de Lugo and the Virgin Islands government to fashion a comprehensive legislative solution to the problems presented by the current system of taxation which would both encourage investment in the Virgin Islands and preserve the integrity of the U.S. tax system. Regretably, H.R. 5985 does not constitute such a solution. The objective of H.R. 5985, to reduce taxes on investments in the Virgin Islands by nonresidents and foreign corporations, particularly those from the U.S. mainland, is important—and is shared by the Treasury Department. While Treasury must oppose the approach taken by H.R. 5985, for the reasons I will discuss, Treasury would be prepared, as an interim measure, to support a reduction in the Virgin Islands withholding tax on payments to U.S. persons.

Description of the bill

Section 1 of the bill would, in a new Code section 934A, reduce from 30 percent to 10 percent the rate of Virgin Islands tax imposed on payments of fixed and determinable income from sources within the Virgin Islands, not effectively connected with a Virgin Islands trade or business, to persons not resident in the Virgin Islands. The tax reduction would apply to payments to persons resident in foreign countries as well as in the United States. New section 934A would also allow the Virgin Islands to further reduce the effective rate of tax by excluding this tax from the scope of the proscription in section 934(a) against direct or indirect reductions in tax liability under the Virgin Islands mirror code.

The new rate of tax on fixed or determinable income would not apply to dividends from earnings and profits accumulated before the effective date of the reduction. For this purpose, dividends would be treated as being derived first from such pre-effective date earnings. A new section 1444 would be added to Chapter 3 of the Code to conform the rate of withholding to the reduced tax rate. The reduced tax rate would apply to amounts received and the withholding provisions would apply to payments made after the date of enactment.

Section 2 of the bill would add a new section 934B to the Code which would allow a U.S. citizen or resident, a resident of Puerto Rico, or a domestic corporation to elect to credit "Virgin Islands withholding taxes" together with certain "deemed paid Virgin Islands taxes" under 902 against U.S. taxes, up to the amount of a person's tax liability after utilization of the regular foreign tax credit. "Deemed paid Virgin Islands taxes" would only include deemed paid taxes determined under section 902 with reference to (i) accumulated profits from Virgin Islands source income and dividends therefrom, and (ii) taxes paid or deemed to be paid by the foreign corporation to the Virgin Islands. The amount of the deemed paid Virgin Islands taxes allowed as a credit would be limited to that portion of the deemed paid Virgin Islands taxes which the dividends taken into account in computing the deemed paid Virgin Islands taxes plus section 78 gross-up for such dividends bears to the total taxable income of the corporation. The election to use this special Virgin Islands foreign tax credit would be annual. Unused credits could be carried back two years (but not to a taxable year ending before the date of enactment) and forward five years, without absorption in years in which the section 934B credit is not elected. The credit would be effective for taxable years ending after the enactment of the Act.

Discussion

I have previously discussed aspects of Treasury's broader concerns regarding the interrelationship between the Virgin Islands and U.S. tax systems. A reduction in the tax on payments of Virgin Islands source fixed or determinable income, such as interest and dividends, to non-Virgin Islands residents or corporations would facilitate the use of the Virgin Islands solely for tax avoidance purposes. Accordingly, we would oppose, in principle, any such reduction while the present problems with the

Virgin Islands tax system exist. However, we are aware of the Virgin Islands pressing needs and that it takes time to agree on broader solutions to such difficult problems. Recognizing this, we would be prepared to support a reduction in the rate of tax on Virgin Islands source payments of fixed or determinable income to U.S., but not foreign, persons, solely as an interim measure. In this way, legitimate investment from the United States would be encouraged during the period that it took to remedy the broader problem.

This policy is consistent with the U.S. tax policy toward Guam. Under the Guam mirror code, a 30 percent tax is imposed on payments of Guam-source fixed or determinable income to foreign corporations and nonresident aliens, but imposes no tax on such payments to U.S. persons. The legislation which the Treasury Department is prepared to support as an interim solution for the Virgin Islands would allow the Virgin Islands, like Guam, to eliminate its tax on Virgin Islands source payments of fixed or determinable income to U.S. persons.

We cannot extend our support to a reduction in the rate of tax on Virgin Islands source payments of fixed or determinable income to foreign persons, that is, persons not resident in or organized under the laws of the United States or the Virgin Islands. A reduction in the rate of Virgin Islands tax, combined with the provisions of the Revised Organic Act, would permit the use of the Virgin Islands as a conduit for investment into the United States by a national of a country with which the United States does not have a tax treaty. This would be contrary to the United States strong policy against allowing residents of non-treaty countries to obtain unbargained-for tax benefits. To the extent that nationals of non-treaty partners can invest in the United States at reduced tax rates without a tax treaty, our ability in tax treaty negotiations to bargain for reductions in taxation of U.S. investment by the host country is compromised. The implications of conduit investments resulting from a reduction in the Virgin Islands tax would also undermine the efforts of this Administration to fashion appropriate protections in our treaties against interposition of a treaty protected entity by third country nationals to invest in the United States.

Treasury must therefore oppose a reduction in the Virgin Islands tax on payments of Virgin Islands source fixed or determinable income to foreign persons.

Finally, Treasury must also oppose the foreign tax credit provisions of the bill. Section 934B addresses the problem of excess Virgin Islands tax credits which results when the total of (i) taxes deemed paid by a Virgin Islands corporation to the Virgin Islands under section 902, plus (ii) the Virgin Islands withholding tax on dividends paid by the Virgin Islands corporation to a U.S. parent corporation, exceeds 46 percent of the amount of the dividend. This problem is obviated if the Virgin Islands tax on payments of Virgin Islands source fixed or determinable income to U.S. persons is reduced.

Treasury would, in any event, oppose an exemption from the application of the foreign tax credit limitation for taxes paid to the Virgin Islands on fixed and determinable income and deemed paid Virgin Islands taxes. Such an exemption would, in certain circumstances, allow these Virgin Islands taxes to offset U.S. taxes on taxable income which is not from the Virgin Islands, including U.S. source taxable income. This is contrary to the policy behind the foreign tax credit limitation, which has been in effect, in "overall" or "per country" form, since 1921. The United States only allows a credit for foreign taxes paid to the extent of the United States tax that would have been paid on the taxpayer's foreign source taxable income. The United States is opposed to offsetting U.S. taxes on U.S. source income with the foreign tax credit because it would constitute a transfer of revenues from the U.S. Treasury to the treasury of the other jurisdiction. Treasury is opposed to increasing the tax based subsidies to the Virgin Islands in this manner.

In this regard, the Committee should be aware that the Administration's Caribbean Basin Initiative legislation includes generous additional tax incentives to invest in the Virgin Islands. These measures include allowing a parent of a domestic "934(b)" corporation to obtain the benefit of a full investment tax credit and 50 percent of the ACRS deductions with respect to eligible property of the domestic "934(b)" corporation.

In summary, the Treasury Department must oppose H.R. 5985, except to support, as an interim measure, a reduction in the Virgin Islands tax on payments of Virgin Islands source fixed or determinable income to U.S. persons.

Mr. Gibbons. This will conclude the hearings for today. We will convene again tomorrow at 9:30 a.m., at which time we will hear Secretary Dole of the Transportation Department.

The meeting is adjourned.

[Whereupon, at 12:10 p.m., the committee was adjourned, to reconvene at the call of the Chair.]

TAX SHELTERS, ACCOUNTING ABUSES, AND CORPORATE AND SECURITIES REFORMS

TUESDAY, FEBRUARY 28, 1984

House of Representatives,
Committee on Ways and Means,
Washington, D.C.

The committee met at 9:30 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman Rostenkowski. The committee will come to order.

Today, the Committee on Ways and Means concludes hearings on the administration's fiscal year 1985 budget proposals relating to tax shelters, accounting abuses, corporate and securities reforms, together with related proposals aimed at eliminating tax-motivated transactions.

Last week, the administration made a persuasive case before this committee for the necessity and equity of their proposals to limit tax benefits from these transactions. Today, the committee looks forward to hearing from Members of Congress and representatives of professional associations and affected members of the general public in order to understand precisely what impact the changes advocated by the administration could have on taxpayers.

As I stated at the hearings last week, the committee is particularly interested in determining the extent to which these proposals might adversely affect legitimate nontax motivated business transactions. It is my hope that, rather than offering simple criticisms, witnesses will suggest constructive refinements to any proposal which appears to be overly broad in its application to legitimate transactions. Only in this way will the committee be able to evaluate objectively these proposals and determine which proposals are appropriate for further consideration or modification by the committee.

In light of the many individuals scheduled to testify today, we will adhere strictly to the 5-minute rule.

It is with great pleasure that I welcome to the committee Hon. Daniel Patrick Moynihan, a Senator of the great State of New York and a good personal friend. Pat, welcome to our committee. We look forward to your testimony and the exchanges that will ensue.

STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM THE STATE OF NEW YORK

Senator Moynihan. Thank you, Mr. Chairman.

To start, sir, I wonder if it would not be useful to note yesterday the Bureau of the Census issued a report which in the most dramatic way makes the case that occasions these hearings. We have now the income data for 1981. In 1981, the family after-tax income declined in the United States. The average income tax paid by Americans grew from $4,000 to $4,300. Taxes went up for the average person. For persons with incomes over $75,000, however, taxes went down from $33,000 to $30,000. We see just the opposite of the promised results of some of those tax bills.

If I may say, Mr. Chairman, half the problem we have with taxation right now as to do with taxes not paid. The Treasury has recently reported that less than half the income of American businesses and individuals is subjected to tax. The rest is sheltered, hidden, avoided in some way or another. In some respects, in raising revenue, one of our principal objects is going to have to be to collect taxes that are already owed.

I have a statement which I would like to put in the record and two examples which I would like to pose. One has more to do with the appearance of the Tax Code. Representative Stark and I have introduced this. Since the 1981 act, there has grown up a practice of firms buying extremely expensive, $100,000 foreign automobiles with the advertisement that to do so provides great tax shelters, that you won't have to pay for the measure, for the automobile, in effect. Half the cost will be written off to tax depreciations or as a tax incentive.

As a very specific proposition, an automobile, a Rolls Royce costing some $108,000, under the present legislation, a company can reduce its tax liabilities by $54,000 simply buying a $100,000 car, limousine for an executive. We propose to have executive limousines limited to $15,000 in terms of tax deductions. You can get a good American car for $15,000. A $15,000 limit will work fine.

More importantly, Mr. Chairman, in terms of the general proposition, we would like to suggest that the time has come to take a wholly new approach and strategy with respect to the problem of tax shelters. If your committee here and our Committee on Finance on the other side keeps running around trying to close this tax shelter and trying to close that tax shelter, it is the equivalent of betting your kidneys against a brewery. There is always going to be somebody thinking up a new shelter as fast as you close an old one.

What we would like to propose is that for purposes of the minimum tax, which is 20 percent of income above $40,000 for a family or an individual taxpayer, that no tax shelter loss be chargeable against earned income and investment income. In other words, no matter how many llama farms you have bought, or how many quarterhorses or whatever the tax shelter is, if it is a tax shelter and generally accepted accounting principles say there is no economic activity and no economic loss, you cannot deduct if from the base of your 20-percent minimum tax.

If you cannot deduct it, you will not get into it. It costs something to get into a tax shelter, and we are trying to make the tax shelters inapplicable to the minimum income. We feel that there are billions of dollars a year that can be gained by such a measure. You go to the problem which is income that people want to shelter, and you make it nonshelterable.

Mr. Chairman, we feel that not only would this deal with present problems, it would deal with future problems. The number of tax sheltering operations since the 1981 legislation has at least doubled in volume. It shows no tendency to decline. It seems to us that the only way to do is to go to the source, which is, say you can have all the losses you want but you can't deduct them from your minimum tax base.

That, in summary, is my thoughts for the occasion, inside 5 minutes, which is not easy for a Senator.

[The prepared statement follows:]

STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM THE STATE OF NEW YORK

Mr. Chairman, Distinguished Members: Thank you for giving me the opportunity to testify today on a matter of importance for the fairness and efficiency of the tax system. This is the proliferation of tax shelters, the near epidemic of investments designed to enable taxpayers to reduce their taxable incomes by more than the amounts they invest. Shelters take the form of investments—and who among us does not want to encourage investment?—and who among us does not want to encourage investment? But these are not economic investments in a true sense. Here, one enters into the investment, not with the expectation of economic profit, but rather with the assurance of tax deductions, credits, and losses. The goal is not to produce a profit, but to reduce the tax liability on one's income from other sources. According to Joseph A. Pechman, Senior Fellow at the Brookings Institution, in "Federal Tax Policy" (1983):

"Tax shelters permit individuals to reduce drastically or even to wipe out tax liabilities on large incomes by taking advantage of preferential provisions in the tax law."

I have no argument here with tax incentives designed to promote economically and socially desirable activities. I must and will oppose tax avoidance schemes designed solely for tax advantages. I am concerned about tax loopholes which merely allow the most wealthy among us to avoid bearing their fair share of the tax burden, thereby increasing the burden on the middle- and lower-income Americans.

I recently introduced legislation, in the Senate, S. 2319, "The Tax Shelter Reform Act of 1984," to address this problem.

This is not a minor, nor idle, matter. Tax sheltering schemes are increasing greatly, both in number and volume. According to a report in U.S. News and World Report of June 13, 1983, Robert A. Stranger & Co., an investment advisor firm, has estimated that total investments in tax shelter partnerships, the primary vehicles for these transactions, increased more than 100 percent from 1980 to 1983, from $5.7 billion to $12 billion, and will reach $14 billion this year. The Stranger firm also estimated that 750,000 individuals invested in tax shelters in 1982, and the numbers are rising. These shelters generally are investments designed to take advantage of a loophole, in which the investor's return mainly is based, not on economic profit, but on tax savings with respect to income from other sources.

The total cost to the Treasury, to ordinary taxpayers, is large, but hard to estimate with precision. Last year, the Internal Revenue Service examined 95,000 tax shelter returns, involving more than $1.7 billion in disputed tax deductions and credits. At this rate, the current IRS backlog of 350,000 questionable returns with tax shelters represents more than $6.5 billion in forgone or potential revenues. As these represent only the most questionable tax shelters—about 10 percent of all sheltering activities, according to estimates by Stranger & Co.—total costs to the Treasury could reach $65 billion.

Mr. Chairman, permit me to explain how these schemes provide a wealthy taxpayer with overly generous tax benefits. Most arrangements are quite a bit more complex, but a basic understanding of tax shelters is necessary in order to combat them.

A classic tax shelter could involve, for example, a machine leased to a farmer. The investor contributes, say, $10,000 in cash, and the tax shelter promoter arranges a $105,000 loan. Of the $115,000, the promoter takes $15,000 and $100,000 is used to buy the machine. The machine investment qualifies for the Investment Tax Credit (ITC) of 10 percent of the entire $100,000 cost, so the investor can subtract $10,000 from his tax liability for that credit. At this point, our investor has invested $10,000 and received a $10,000 tax credit from the U.S. Treasury. But the investor is also entitled to additional tax breaks, in the form of depreciation deductions, because the machine can be "written-off" or "depreciated" over five years.

The Accelerated Cost Recovery System (ACRS) provides for a 15 percent tax deduction based on the machine's total cost, in the first year. In addition to the $10,000 tax credit, therefore, the investor would claim a deduction of almost $15,000 in the first year. For an investor in the 50 percent tax bracket, this deduction is worth nearly $7,500 in tax avoidance. Finally, the taxpayer can deduct any payments for interest on the $100,000 loan. This last deduction usually offsets the tax liability of any income derived by the investor from leasing the machine to the farmer. Thus, the investor who puts up $10,000 has gained immediately tax benefits of $17,500.

Our investor, moreover, continues to collect tax savings in succeeding years without any additional investment. In year two, the interest deduction continues to offset the tax liability for the leasing income, while the depreciation deduction rises to 22 percent. This means the tax shelter investor can claim a new deduction of almost $22,000, equivalent to a tax credit of almost $11,000 if he, like the typical tax shelter investor, is in the 50 percent bracket. This return of almost two dollars in tax reductions for every dollar invested, just in the first year, and about $28,000 in tax savings over two years for a $10,000 investment, is not unusual. Under more complex arrangements, the investor can generate even greater tax savings. The investor's depreciation deductions continue for three more years, moreover, and if he ever sells the property any gain will be taxed at preferential long-term capital gains rates.

For the promoter and purchaser of a tax shelter, the object of investment matters little—real estate, equipment leasing, oil and gas exploration, industrial research and development projects. These are the foci of tax shelters, because these are the kinds of investments for which Congress has provided the greatest number and breadth of tax incentives.

Tax shelter schemes have proliferated despite passage of the Tax Equity and Fiscal Responsibility Act of 1982 and its provisions curtailing shelters. According to a Washington Post report of November 6, 1983:

"Congress and the Internal Revenue Service have taken a series of steps to tighten up regulation of tax shelters, but to no avail. the market in tax-based limited partnerships continues to come up with new ways to skirt the edge of the law."

Other analysts agree. For example, a Wall Street Journal article of February 15, 1984, reported that many legitimate partnerships syndicators feel that many partnerships being sold today make little or no economic sense, apart from their tax deductions.

Efforts by the IRS and the U.S. Tax Court to stem abusive tax sheltering activities have been hindered by the sheer volume of cases. At the close of 1982, 300,000 tax returns with tax shelter arrangements were in the examination process at the IRS. One year later, the Service had completed examinations of 95,000 returns with tax shelters, but the backlog had reached 350,000 returns. According to the Joint Committee on Taxation, 20,000 cases involving tax shelters, representing asserted tax deficiencies of $1.4 billion are pending now before the Tax Court.

The proliferation of tax sheltering activity not only costs the Treasury great sums and strains the capacity of the IRS and the U.S. Tax Court, it also threatens our essentially voluntary system of tax collection. The IRS audits roughly 1.5 percent of all returns filed. As 98.5 percent of all returns are not audited, we must rely on most taxpayers to report correctly their income tax liabilities. So far this has worked because Americans are honest and because Americans believe that the tax code is essentially fair. The proliferation of tax shelters, designed almost exclusively to reduce the tax liability for wealthy investors, undermines these vital beliefs. A recent study by the Joint Tax Committee emphasized this point, stating:

"A major concern is that the highly visible marketing of tax shelters, and the accompanying belief that the Internal Revenue Service cannot deal with them, may erode taxpayers' confidence in the fairness and effectiveness of the tax system. Sociological research supports the proposition that taxpayers are more likely to comply with the tax laws when they perceive the system to be fair or when the costs of noncompliance are perceived as relatively high and relatively certain. The widespread use of tax shelters deprives the system of its claim to fairness and retards the administrative and judicial processes to the point that penalties seem neither certain nor costly.

In the present era of immense budget deficits, we can no longer tolerate tax expenditures with little or no economic justification, nor can we tolerate a tax system which permits the most wealthy among us to escape their fair tax liabilities.

My "Tax Shelter Reform Act of 1984," S. 2319, would represent an important advance against abusive tax sheltering activities. I want to briefly discuss two sections of that bill with you. First the limitation on deductions with respect to luxury limousines, and second, reform of the minimum tax.

The provision to limit business tax breaks for luxury cars is the Senate counterpart to Congressman Stark's bill, H.R. 4235. Under present law, the cost of automobiles used in trade or business or in connection with an income-producing activity is deductible, using the 3-year depreciation schedule under the accelerated cost recovery systen (ACRS): 25 percent in the first year, 38 percent in the second year, and 37 percent in the third year. In addition, a 6 percent investment tax credit (ITC) can be claimed in the first year. The only limit on these tax benefits, under current law, is the purchase price of automobiles. As a result taxpayers receive greater tax benefits if a $100,000 luxury limousine is purchased than if a $10,000 automobile is purchased. My concern is that through these tax benefits, the Treasury is subsidizing the purchase of luxury limousines by many businesses for use by their top executives.

My bill would amend section 168(d) of the Internal Revenue Code to limit the tax benefits, the tax subsidy, for business purchases of luxury passenger automobiles. The basis of such autos would be limited to $15,000 subject to an annual adjustment based on the automobile component of the Consumer Price Index (CPI). Those vehicles engaged directly in providing transportation services, such as ambulances, hearses, and airport limousines, would not be subject to this limitation. Trucks, of course, also would not be affected by this limitation. Under my bill, a business could not avoid the effects of this provision, however, by leasing its limousines—in that situation it would only be allowed to deduct the fair market value of a lease on an automobile costing $15,000.

This provision would not prevent businesses which own luxury cars from depreciating them under ACRS and claiming the ITC credit. It simply would limit the basis used in computing the ACRS and ITC benefits to $15,000, and impose a similar limit on long-term leases of such luxury automobiles.

There are two basic reasons to limit the favorable tax treatment currently being accorded businesses for luxury cars. First, many of these luxury cars have become good investments maintaining much of their original value. For example, a Mercedes-Benz 300SD four-door sedan sold in 1979 for $22,000; today that 1979 car sells for $17,500. This represents a depreciation of less than 25 percent over four years. After four years the vehicle retains over 75 percent of its original value, while current tax law would permit the owner to depreciate it completely in 3 years. Similar statistics apply to BMWs and, of course, to Rolls Royces. Indeed, certain luxury cars have become classics, actually increasing in value. To grant the depreciation allowed by ACRS without a dollar limit for luxury cars fails to account for the non-depreciating quality of some of these cars.

The second reason to place a limit on these luxury cars is to recognize that there are quality automobiles used today which cost well under $15,000 in the United States that provide perfectly suitable business transportation. The average retail price of new cars in 1983 was about $11,000. A luxury car, on the other hand, provides more than transportation—it lends a certain prestige to the occupants of the vehicle. Anyone who wishes to purchase such prestige can do so, with his own money. That is his business. But the additional prestige and comfort associated with luxury cars, used by business executives, should not be subsidized by the rest of the American taxpayers. That is what this provision proposes to change.

The provision would also limit the Treasury subsidies for the use of luxury limousines by business taxpayers who lease luxury limousines rather than purchasing them. The provision imposes a limit on the amount of an automobile lease that can be deducted as an ordinary and necessary business expense. For automobile leases longer than one month, a taxpayer would only be allowed to deduct the rental costs attributable to a $15,000 automobile.

Cars used for the transportation requirements of a trade or business properly generate tax advantages. But luxury cars, by definition, provide more than just transportation to the user.

I note in passing, that this bill would not violate the General Agreement on Trade and Tariffs (GATT). First, GATT only applies to excise and sales taxes, not to income taxes. Second, the bill is not intended to discriminate against imports. Finally, the impact is greater on U.S. manufactured cars than on foreign-manufactured cars. For example, in 1983 477,518 U.S. manufactured cars priced over $15,000 were sold in the United States, while only 305,041 foreign manufactured cars over that price were sold. Finally, I note that this provision will raise $400 million over the next three years.

The second provision I will discuss involves the minimum tax. How fair is it, when thousands of Americans enjoy high annual incomes, but pay little or no personal taxes? How efficient is it when the Tax Code permits—nay, encourages—investments in tax shelters producing little or no economic benefit. I submit that there is more than a casual relationship between these matters of equity and efficiency. It is by the use of tax shelters that some of the wealthiest among us manage to avoid paying any income tax.

Certainly, it is not the intention of the Tax Code to permit persons with high incomes to escape any tax liability. But it is the effect. We have, after all, progressive tax rates, which suggest that the richest among us, who can best afford to do so, should contribute the most to the Nation's common revenues. It is equally acknowledged in the Tax Code, however, that this progressivity can be moderated through tax deductions and credits for such recognized purposes as paying mortgage interest, medical expenses, or taking business losses. And there is a separate and distinct recognition that everyone who can afford to do so should contribute something, a minimum contribution.

This is the "alternative minimum tax" under current law, requiring 20 percent tax on income above $40,000 (for couples, filing joint returns). This, quite truly, is a minimum: 20 percent is the marginal rate for ordinary income at about $15,000; it also is the preferential rate for long-term capital gains in the highest bracket.

It doesn't work. it doesn't work, because high income persons can still shelter their incomes not only from progressive tax rates but from the minimum rates as well.

The current minimum tax doesn't work, because high income persons can still use tax shelters to reduce their taxable incomes below the $40,000 level that triggers the minimum tax. By strengthening and expanding the minimum tax, we can at once undercut the attraction of tax shelters and ensure contributions by everyone. This is an approach with both equity and efficiency to recommend it.

It is not uncommon for a tax shelter scheme—say a partnership formed to borrow funds and to purchase and lease a building or farm equipment—to generate $2.00 or more in paper "losses"—mainly, depreciation deductions—for every $1.00 invested. That means a high-income person with, say, $200,000 in income from salary, dividends, and interest can invest in a tax shelter that generates, say $150,000 in "paper losses". That would leave the taxpayer with about $50,000 in taxable income, from which he might well deduct additional amounts for charitable contributions, medical expenses, the interest on his home mortgage, personal exemptions for himself and his family, and the like. Just as the tax shelter enables him to avoid the 50 percent progressive rate on income of $200,000, so it also enables him to evade the 20 percent minimum tax on income above $40,000.

This should tell us how we can begin to restore minimum equity and efficiency to the Tax Code: in computing taxable income, for the purposes of the minimum tax, the taxpayer can now use deductions from tax shelter investments to offset gains from these activities. These "paper losses," however, should not be used to offset income from other sources.

Under my proposal, he would not be able to shelter his income from the minimum tax. The taxpayer still could claim his personal deductions for mortgage interest and the like. The taxpayer still could deduct real losses from business or trade activities in which he is actively involved. But "paper losses" from tax shelter activities could be used only to offset gains from those activities. If these losses exceed these gains, then he could carry over any unrealized losses to the next year, when he does have gains. What he could not do is use these "paper losses," to shelter other income from not only the regular progressive tax, but also from the minimum 20 percent tax on income above $40,000.

At once, we can ensure that everyone who can pay something does so—in particular, that taxpayers with income above $40,000 will pay something on any income above $40,000. At the same time, we can also strike a blow at the near epidemic of economically inefficient tax sheltering. This simple measure would remove a taxpayer's incentive to shelter all his income. This truly is a matter of some real importance, for the efficiency of our economy as well as the equity of our tax system.

Below I have summarized the other provisions of my Tax Shelter Reform Act.

Thank you again for the opportunity to appear there today.

SUMMARY OF THE TAX SHELTER REFORM ACT OF 1984, S. 2319

Section 101. A provision to strengthen existing law prohibiting the use of business tax credits and deducations for investments in property used—through swapping arrangements—for personal rather than business purposes.

Section 102. A provision to deny any tax credit or deduction to taxpayers who overvalue or undervalue property to inflate their tax deductions and credits. The penalty would apply only to abusive misrepresentations: overvaluations of at least 100 percent and undervaluations of at least 50 percent.

Section 103. A provision to strengthen the existing alternative minimum tax on individuals to ensure that taxpayers with incomes of $40,000 or more (joint returns), after personal deductions, are subject to at least a 20 percent tax rate.

Section 104. A provision to limit the tax benefits available to businesses which purchase or lease luxury limousines for use by executives.

Section 105. A provision to require taxpayers to declare any interest income from short-term securities in the same year they deduct interest payments on money borrowed to purchase the securities. (Under current law, a taxpayer can create a tax straddle with certain short-term securities by taking prompt deductions associated with the investment while deferring tax on the interest earned on those securities.)

Section 106. A provision to require any corporation or partnership organized for tax shelter purposes to file with the Internal Revenue Service duplicates of materials they are currently required to file on with Federal and State agencies which regulate security offerings.

Section 107. A provision to require the Treasury Department to examine and analyze a range of specific tax shelter issues and report its recommendations for curtailing the most abusive and unproductive tax shelters.

Chairman ROSTENKOWSKI. Thank you, Senator. As you know, the 5-minute rule applies to everyone, is not restricted and does not apply only to you as a Senator.

Mr. Stark will inquire.

Mr. STARK. Thank you, Mr. Chairman, and I welcome my colleague and friend from New York before our committee, and join with him in suggesting that we do bring some sanity into the tax shelters, and a couple of questions.

You have raised in your testimony, I am told, but I have not found it quickly, that some of the opponents to our bill on luxury autos may raise the scepter of GATT, and I think you are aware that the CRS has given us a lengthy opinion that it does not violate GATT, and second, that France and Japan have taxes which limit the size of cars. France has a 33⅓-percent value added tax.

So that while the issue was raised in GATT and the United States has advanced those arguments in GATT, we have lost, which the opponents to our bill will probably fail to mention in their testimony. But are you comfortable, Senator, that our bill is absolutely legal under the GATT law in principle and in no way violates it?

Senator MOYNIHAN. I thank you for asking the question, sir. I am absolutely of that view. The Congressional Research Service, the legislative attorney for the American Division of CRS, has provided us this statement:

> It is generally acknowledged that these GATT provisions apply to internal taxes on products such as sales, turnover, and gross receipts taxes, and not to income taxes, which are viewed as taxes on individuals and firms.

And what we have, sir, is a spectacle of corporations using our Tax Code to provide extraordinary luxurious cars for their executives which they would never buy absent our Tax Code.

Mr. STARK. Let me ask one further question, if I may, Senator. I share your feeling about tax shelters. You illustrate some farm equipment in your testimony, and I now find that dairy cattle, for instance, get an investment tax credit on the one hand. I always thought they were Guernsey, Holstein. I understand that Hertz and Avis are the new breeds of dairy cattle that are most popular in your dairy State.

While on the one hand we are giving people subsidies for milk, or supposed to cut back on production, we are paying farmers on the one hand to cut back. Does it make any sense on the other hand to encourage them through the Tax Code to breed more dairy cattle?

Senator **Moynihan**. Well, if you want to be a loony enough country, and you enjoy looniness, yes. I mean, if you want to present Government as a set of irrationalities, yes. But if you want to collect taxes and let farmers do farming and not investment bankers do farming, which makes no sense at all.

Mr. **Stark**. We have one more question, and this hits a little close to home, but I think you will join me in this. While I have worked, and I know the Senator has worked long and hard to provide reasonable assistance to low income housing and housing for the elderly, that if we are to create some kind of tax inducements for that type of housing, it should be reasonable for us to expect to see the housing units develop, should it not, rather than just let one investor in the chain of investments build 10 units. It seems to me the inducement ought to get the 10 units built for low income or elderly, and it ought not to be an inducement to buy those 10 units three times down the line to some group of investors years and years after the units were built. Would you agree?

Senator **Moynihan**. That is exactly what is happening, and it would not happen save for the Tax Code.

Mr. **Stark**. I appreciate the Senator's candor in that.

I yield back the balance of my time.

Chairman **Rostenkowski**. Are there any further questions?

Mr. Pease will inquire.

Mr. **Pease**. Mr. Chairman, I just want to commend Senator Moynihan for his testimony, especially for his suggestion of a minimum tax which excludes paper losses. I mentioned a similar concern at our hearing last week. As we closed some tax loopholes, some enterprising attorneys and accountants are going to find some others. Your approach seems to me to be very, very sound.

Senator **Moynihan**. Mr. Pease, may I make a suggestion? Count the number of people on that side of the room, and then count the number of people on the other side of the room, and see what the odds are that you will stop all of those loopholes.

Mr. **Pease**. That is a good point.

Chairman **Rostenkowski**. Mr. Flippo will inquire.

Mr. **Flippo**. Mr. Chairman, thank you.

Senator, I did have one request. I believe you made a very important statement at the beginning of your testimony about the impact upon the average individual taxes and what happened. I believe you indicated that it went up some 300, and that those who earned over—could you give us your source?

Senator **Moynihan**. Yes, sir, the Bureau of Census yesterday issued its annual report on household income.

Mr. **Flippo**. And that was for 1981?

Senator **Moynihan**. For 1981. In 1981, average household income after taxes dropped 2.6 percent. The average Federal income tax for all households paying income tax rose from $4,011 in 1980 to

$4,332, but for families with incomes over $75,000, it dropped from $33,041 to $30,274. The proportion of poor people paying Federal income taxes rose from 7.7 percent to 10 percent between 1980 and 1981.

Mr. FLIPPO. Thank you very much. Thank you, sir.

Chairman ROSTENKOWSKI. Thank you very much, Senator.

Mr. Moore will inquire.

Mr. MOORE. Thank you, Mr. Chairman.

Just a comment. My colleague from California, who normally asks very inquiring questions, went to meddling there when he talked about the dairy industry. Dairy farmers receiving investment tax credits for dairy cattle and participating in a Government subsidized milk program are no different than wheat farmers, corn farmers, or anybody else. Dairy farmers are not getting anything any other farmer does not also get investment tax credit on, farm equipment or whatever. Other types of farmers participate in the Government subsidized agriculture program. I would just point that out.

Senator MOYNIHAN. Mr. Moore, could I just say that you are, of course, right. I lived on a dairy farm, and have done so for 20 years, and all around me are dairy farmers. They do not think it makes sense, and the fact that it is legal does not make it sensible. That is my point.

Mr. MOORE. Well, my only point is, if we are going to get into that, we ought to get into it for all farming, and not just a single one, and to just simply deny——

Mr. STARK. Would the gentleman yield?

Mr. MOORE. Certainly.

Mr. STARK. I would suggest to my colleague from Louisiana and to the Senator that I have been taking notes. I understand that there is investment tax credit for wheat combines when we are giving huge PIK payments, and I have heard people say, why single out Mercedes and Rolls-Royce? What about the expensive office furniture? And as I say, I am willing to add with the Senator's help if he hears a lot of these things and wants to add them on the Senate bill. He would get no fight from me when it came back here. We could expand these things ad infinitum, and raise some of that revenue so necessary to balancing the budget.

Chairman ROSTENKOWSKI. Thank you very much, Senator. I would just like to caution my colleague from California, Mr. Stark, to not take too many people on.

Thank you very much, Senator.

Senator MOYNIHAN. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. The Chair calls Hon. Ron de Lugo. Ron, welcome to the committee. We look forward to your testimony.

STATEMENT OF HON. RON DE LUGO, A DELEGATE IN CONGRESS FROM THE VIRGIN ISLANDS

Mr. DE LUGO. Thank you very much, Mr. Chairman.

I am joined by the Governor of the Virgin Islands, Gov. Juan Luis, and Jay Kraemer, who is associated with us.

Mr. Chairman, I thank you for this opportunity to comment on H.R. 4072. While the bill targets a Puerto Rico activity, the Virgin Islands is included in the package. My concerns regarding this bill are essentially technical in nature, but very important to the territory of the Virgin Islands.

First of all, I appreciate the clear purpose addressed in this legislation, not to confuse this as a rum-related issue. This is important to me because it means that it is understood that there has been no objection raised with regard to the rum industry, that the rum distillation process is entirely local, and that the rum industry is integral to the Virgin Islands and Puerto Rico economically as well as culturally.

There is no doubt that "product of" under section 7652 reaches the rum industry and was intended to do so. Rum products have historically been excise taxable items which targeted the cover-over of revenues required by section 7652. Without rum, the statute would have little meaning. The rum industry in the Virgin Islands, however, includes distillation to one proof higher than our distillation proof for rum. The resulting 190 proof distillate is typically used in the mixture of cordials, liqueurs, and specialties. This product results from the same materials and process as rum, and for the same reasons should be excluded under subsection 5 of the bill.

I understand that there is some concern that exempting cane neutral spirits opens the possibility of Puerto Rico or the Virgin Islands entering the vodka and gin market. I believe that the economics of the situation, the cost of molasses in addition to the shipping and processing cost would make this an unattractive proposition. In any case, I would be pleased with an exception which exempted cane neutrals other than those sold as gin or vodka. This would leave us in the market for cane neutrals such as cordials, specialties, and liqueurs.

I would also like to see subsection 5 amended to exempt cocktails premixed in the Virgin Islands. These cocktails are rum mixed with flavoring which are bottled and sold as premixed pina coladas, daiquiris, and the like. Again, the product is mostly rum and should come under section 7652.

Similarly, the concern has been raised with tax staff that Virgin Islands rum shipped to the mainland but mixed with flavoring to make cocktails prior to leaving tax bond will be precluded from excise tax returns under H.R. 4702. Tax staff invited representatives from the Bureau of Alcohol and Tobacco to meet with members of Mr. Corrada's and my staffs to explain that activity occuring after the product leaves Puerto Rico or the Virgin Islands is not relevant with regard to the excise taxes due either on their product. I would appreciate your including this clarification in the committee report for the benefit of all who may otherwise have been misled on this. I am concerned that the scope of H.R. 4072 is overbroad.

I understand the desire to narrow section 7652. This, I submit, could be done by replacing subsections 2 and 3 with a requirement that Treasury report to this committee and the Senate Finance Committee on any product which the Secretary determines was produced in Puerto Rico or the Virgin Islands because of a subsidy based on section 7652.

The reporting requirement would put Puerto Rico and the Virgin Islands on notice as well as any industry inclined to venture into production based on such a subsidy. Furthermore, the excise taxes generated by the suspect product could be escrowed pending congressional review. This would eliminate any possible incentive to factor in the revenues to be generated during the review of a questionable operation.

I believe this approach is preferable, particularly since subsection 2 of the bill imposes a separate trade test in this tax context, one that is different from the Customs test on which the Virgin Islands products enter the United States. As you know, we are outside of the Customs law. Virgin Islands products enter duty-free under Headnote 3(a) of the Tariff Schedules of the United States.

Two separate definitions of Virgin Islands products are bound to cause confusion, and could have the unintended result of affecting the existing Customs analysis. These very real concerns of the Virgin Islands do not affect Puerto Rico to the same extent as Puerto Rico is inside of the U.S. Customs territory. The Virgin Islands stands to suffer a greater hardship than Puerto Rico under the current formulation.

Thus, in the alternative to the reporting suggested above, I ask that, as with Senator Long's companion legislation in the other body, the Virgin Islands not be included in subsection 2 of the bill.

As I suggested earlier, Mr. Chairman, I wish to thank the committee. This committee has been open to input from my office prior to today's hearing, and I appreciate this very much, and I remain willing to work with the committee members and staff to assure that this legislation reaches the problem with which we are all concerned, and that it does so without creating difficulty for the Virgin Islands with regard to the congressionally created and longstanding basis for determining the identity of Virgin Islands products and the excise taxes that we are receiving from them.

I want to thank you very much, Mr. Chairman, and I would turn it over now.

Mr. GIBBONS [presiding]. Mr. de Lugo, we thank you, and we want to note publicly that you are often a visitor here because of the unique problems of the Virgin Islands, and you do an effective job of keeping us alerted to those problems. I notice that you have Gov. Juan Luis with you this morning, and I wonder if the Governor would like to be recognized.

STATEMENT OF HON. JUAN LUIS, GOVERNOR OF THE U.S. VIRGIN ISLANDS

Mr. LUIS. Mr. Chairman, and distinguished members of this committee, I thank you for this opportunity to comment on legislative proposals before this committee, particularly H.R. 4702, to clarify the definition of distilled spirits produced in Puerto Rico or the Virgin Islands for purposes of determining the amounts of Federal excise taxes which are paid over to Puerto Rico and the Virgin Islands.

It is my understanding that these proposals are a response to a program established in Puerto Rico within the last several years where alcohol originally distilled in the United States is shipped to

Puerto Rico for redistillation and then reshipped to the United States. The sole purpose of this program appears to be to remanufacture a product in Puerto Rico that otherwise would be produced in the United States in order for Puerto Rico to collect the $10.50 per gallon Federal excise tax pursuant to section 7652 of the Internal Revenue Code.

Permit me to say for the record that the Virgin Islands does not now engage nor has it ever engaged in such a redistillation program. The Government of the Virgin Islands does not believe that the redistillation of alcoholic spirits of the sort described above results in the type of product that was intended to be covered by the rebate provisions of section 7652.

Accordingly, the Government of the Virgin Islands does not oppose the thrust of H.R. 4702 which would eliminate this particular practice. However, we are concerned that the language of any legislation adopted by this committee be drafted in a careful manner to avoid restricting legitimate manufacturing and distilling operations in the Virgin Islands.

I am pleased to note in this regard that representatives of my office have had productive meetings with the staffs of both the Ways and Means Committee and the Senate Finance Committee in an effort to resolve certain technical problems presented by these legislative proposals. We understand that the legislation is not intended to affect the rebate of excise taxes on rum produced in Puerto Rico or the Virgin Islands.

As this committee is aware, the rebate of rum excise taxes is one of the fiscal cornerstones of the Virgin Islands' relationship with the United States. Originally enacted as part of the 1954 Revised Organic Act of the Virgin Islands, and later codified in section 7652 of the Internal Revenue Code, the rebates of rum excise taxes has been a prime force in financing the economic development of the Virgin Islands, and has lessened its fiscal dependence on the Federal Government. In the last year, rum excise taxes accounted for almost 20 percent of the entire Virgin Islands budget.

We also understand that the legislation is not intended to affect other distilled spirits such as cane neutral spirits or products in which rum is the primary component if substantially all such spirits are originally distilled in Puerto Rico or the Virgin Islands. New subsection C(1) of Code 7652 as provided in H.R. 4702 is drafted to allow the Virgin Islands to continue to collect the excise tax on cane neutral spirits, high proof molasses based spirits, and rum originally distilled in the Virgin Islands and later shipped to the United States for blending to produce rum-based cordials and premixed rum cocktails.

However, because of the value-added requirement under proposed subsection C(2) and the subsidy prohibition under proposed subsection C(3), it is unclear whether such products would be considered Virgin Islands products for purposes of Code section 7652. We believe that this problem may be remedied by adding a technical clarification to the definition of rum in the exceptions provision under proposed subsection C(5).

We are also concerned that the scope of H.R. 4702 may be unnecessarily broad. We believe that the requirement that substantially all if any distilled spirits be originally distilled in Puerto Rico or the Virgin Islands in order to trigger the rebate provisions of section 7652 is sufficient to eliminate any possible abuse.

We appreciate the intent of the committee to insure against any abuses with respect to any other product of the Virgin Islands or Puerto Rico. However, we believe that this objective may be readily obtained by simply requiring the Secretary of the Treasury to report to the Ways and Means Committee and the Senate Finance Committee any attempt to obtain a transfer of funds pursuant to code section 7652 with respect to any article or articles that the Secretary determines would not have been produced in Puerto Rico or the Virgin Islands but for the existence of section 7652.

In sum, the Virgin Islands does not oppose the efforts of this committee to clarify the law with respect to the propriety of the redistillation of liquor in Puerto Rico or the Virgin Islands. In that spirit, we are willing to work with the members and staff of this committee to eliminate genuine abuses and to insure that any legislation does not unintentionally exclude legitimate products of the Virgin Islands from the scope of code section 7652.

Thank you very much, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF HON. JUAN LUIS, GOVERNOR OF THE U.S. VIRGIN ISLANDS

Mr. Chairman and Distinguished Members of the House Ways and Means Committee, I am pleased to have the opportunity to comment on legislative proposals before the Committee, particularly H.R. 4702, to clarify the definition of distilled spirits produced in Puerto Rico or the Virgin Islands for purposes of determining the amounts of Federal excise taxes which are paid over to Puerto Rico and the Virgin Islands.

It is my understanding that these proposals are a response to a program established in Puerto Rico within the last several years where alcohol originally distilled in the United States is shipped to Puerto Rico for redistillation and then reshipped to the United States. The sole purpose of this program appears to be to "remanufacture" a product in Puerto Rico that otherwise would be produced in the United States in order for Puerto Rico to collect the $10.50 per gallon federal excise tax pursuant to Section 7652 of the Internal Revenue Code ("Code").

Permit me to say for the record that the Virgin Islands does not now engage, nor has it ever engaged, in such a redistillation program. The Government of the Virgin Islands does not believe that the redistillation of alcoholic spirits of the sort described above results in the type of "product" that was intended to be covered by the rebate provisions of Section 7652. Accordingly, the Government of the Virgin Islands does not oppose the thrust of H.R. 4702, which would eliminate this particular practice.

However, we are concerned that the language of any legislation adopted by this Committee be drafted in a careful manner to avoid restricting legitimate manufacturing and distilling operations in the Virgin Islands. I am pleased to note in this regard that representatives of my office have had productive meetings with the staffs of both the Ways and Means Committee and the Senate Finance Committee in an effort to resolve certain technical problems presented by these legislative proposals.

We understand that the legislation is not intended to affect the rebate of excise taxes on rum produced in Puerto Rico or the Virgin Islands. As this Committee is aware, the rebate of rum excise is one of the fiscal cornerstones of the Virgin Islands' relationship with the United States. Originally enacted as part of the 1954 Revised Organic Act of the Virgin Islands and later codified in Section 7652 of the Internal Revenue Code, the rebate of rum excise taxes has been a prime force in financing the economic development of the Virgin Islands and has lessened its fiscal dependence on the federal government. In the last year, rum excise taxes accounted for almost 20 percent of the entire Virgin Islands budget.

We also understand that the legislation is not intended to affect other distilled spirits, such as cane neutral spirits or products in which rum is the primary component, if substantially all of such spirits are originally distilled in Puerto Rico or the

Virgin Islands. New Subsection (c)(1) of Code Section 7652, as provided in H.R. 4702, is drafted to allow the Virgin Islands to continue to collect the excise tax on cane neutral spirits (high proof molasses-based spirits) and rum originally distilled in the Virgin Islands and later shipped to the United States for blending to produce rum-based cordials and pre-mixed rum cocktails.

However, because of the value added requirement under proposed Subsection (c)(2) and the subsidy prohibition under proposed Subsection (c)(3), it is unclear whether such products would be considered Virgin Islands products for purposes of Code Section 7652. We believe that this problem may be remedied by clarifying the exceptions provision in proposed Subsection (c)(5) to provide that proposed Subsection (c) shall not apply "(A) to rum as defined in Subsection (d)(3), to cane neutral spirits, or to any other article subject to a Federal excise tax on distilled spirits of substantially all of the distilled spirits in such article consist of rum, cane neutral spirits, or both, or (B) to any article consumed in Puerto Rico or the Virgin Islands (as the case may be)."

We are also concerned that the scope of H.R. 4702 may be unnecessarily broad. We believe that the requirement that substantially all of any distilled spirits be originally distilled in Puerto Rico or the Virgin Islands in order to trigger the rebate provisions of Section 7652 is sufficient to eliminate any possible abuse. We appreciate the intent of the Committee to insure against any abuses with respect to any other product of the Virgin Islands or Puerto Rico. However, we believe that this objective may be readily obtained by simply requiring the Secretary of the Treasury to report to the Ways and Means Committee and the Senate Finance Committee any attempt to obtain a transfer of funds pursuant to Code Section 7652 with respect to any article or articles that the Secretary determines would not have been produced in Puerto Rico or the Virgin Islands but for the existence of Section 7652.

We believe that this approach is preferable to the approach embodied in proposed Subsections (c)(2) and (c)(3) of H.R. 4702. In particular, we are concerned that the value added requirement under proposed Subsection (c)(2) represents an entirely different test for defining a Virgin Islands "product" for purposes of Code Section 7652 from the test established by Congress for purposes of duty-free entry of Virgin Islands "products" into the United States pursuant to General Headnote 3(a) of T.S.U.S. We believe that the establishment of two different tests for defining a Virgin Islands "product" would be confusing at best and discriminatory at worst.[1] In this respect we note that the Virgin Islands is in a different situation from that of Puerto Rico, since the Virgin Islands, unlike its sister territory, is outside of the U.S. customs territory and has traditionally relied on the General Headnote 3(a) test to determine what is and is not a Virgin Islands "product." Recognizing this important difference, the sponsors of the Senate version of H.R. 4702 (S. 2246) deleted the value added requirement for Virgin Islands products. We would urge this Committee to do likewise.

In sum, the Virgin Islands does not oppose the efforts of this Committee to clarify the law with respect to the propriety of the redistillation of liquor in Puerto Rico or the Virgin Islands. In that spirit, we are willing to work with the Members and Staff of this Committee to eliminate genuine abuses and to insure that any legislation does not unintentionally exclude legitimate products of the Virgin Islands from the scope of Code Section 7652.

Mr. GIBBONS. Thank you, Governor. And I notice, Mr. de Lugo, you also have counsel for the Virgin Islands rum industry. Does the counsel, Mr. de Lugo, want to make a statement?

STATEMENT OF JAY R. KRAEMER, COUNSEL, VIRGIN ISLANDS RUM INDUSTRIES, LTD., AND SCHENLEY INDUSTRIES, INC.

Mr. KRAEMER. Yes, Mr. Chairman.

In the interest of time of the committee, I can have my printed statement put in the record, but I would summarize briefly.

Mr. GIBBONS. Yes, please. If you have a formal statement, we will put it in the record.

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[1] We note that the 50 percent value added requirement embodied in new subsection (c)(2) is a more stringent test than the test Congress enacted as part of the Caribbean Basin Initiative for duty-free entry of Caribbean products.

Mr. **Kraemer**. Mr. Chairman and members of the committee, my name is Jay Kraemer. I am a partner in the firm of Fried, Frank, Harris, Shriver & Kampelman. We represent Schenley Industries, Inc., which is the parent of Virgin Islands Rum Industries, Ltd., the major producer of rum in the Virgin Islands.

I would simply associate my client and myself with the remarks made by the Governor and Congressman de Lugo. We do not believe that it is appropriate that alcoholic beverages redistilled in the Virgin Islands or in Puerto Rico should be subject to the rebate of the excise taxes. On the other hand, we feel that alcoholic beverages originally distilled in the Virgin Islands from molasses, whether it be rum distilled to 189 degrees proof or cane neutral spirits, the same material distilled to 190 degrees proof, we believe that ought to be subject to the rebate of excise taxes.

Now, there has been some concern expressed over whether mixtures of the rum mixed in the United States or mixed in the Virgin Islands would come within the language of the bill. We have been very successful, I think, in working with the staff of the committee to iron out these problems. I understand BATF will submit something to clarify that, but the basic view that we take is, if it is originally distilled in the Virgin Islands from cane molasses, which is a Caribbean product, then that ought to be subject to the excise tax.

[The prepared statement follows:]

STATEMENT OF JAY R. KRAEMER, ON BEHALF OF SCHENLEY INDUSTRIES, INC.

Mr. Chairman, members of the committee, my name is Jay R. Kraemer. I am a partner in Fried, Frank, Harris, Shriver & Kampelman. We represent Schenley Industries, Inc. with respect to its wholly-owned subsidiary, Virgin Islands Rum Industries, Ltd. (VIRIL). I would like to thank the Committee for this opportunity to present Schenley's views.

In the first instance, I would like to express to Congressmen Stark and Moore, the sponsors of H.R. 4702, our appreciation for their exclusion from the application of that bill of VIRIL's principal product, rum, and for the fine cooperation of Mr. Jonas, Mr. Vaughn, and other members of the staff. We understand that it is not the activities of VIRIL or others in the Virgin Islands which are the focus of the Stark/Moore bill, and that, in fact, the bill is not intended to restrict or curtail VIRIL's original distillation of sugar cane molasses.

Schenley supports the views expressed by Congressman de Lugo and Governor Luis that the bill, as introduced, goes beyond what is necessary adequately to protect the U.S. Treasury against present or possible future abuses of § 7652 of the Internal Revenue Code. We believe that a less thoroughgoing change, as Cong. de Lugo has described, would better serve all legitimate interests at this time. Should this Committee decide, however, to recommend a thorough restructuring of § 7652, we hope you will take into account the following specific concerns and limit the scope of legislation accordingly.

Schenley is concerned that H.R. 4702, as introduced, would unduly constrain VIRIL's production of cane molasses distillates for shipment to the U.S. One concern is with respect to premixed cocktails which contain rum from the Virgin Islands. For these items, the rum is shipped to the U.S. and is mixed, as pina colada or other rum-based drinks, before it leaves Internal Revenue bond. We understand, however, that the Bureau of Alcohol, Tobacco and Firearms is preparing a statement for the legislative record clarifying its intent to focus on the status of the rum, as rum, at the time it physically arrives in the United States, rather than on the article which leaves Internal Revenue bond. In other words, we understand BATF will make clear that the Virgin Islands is to receive a tax rebate on rums distilled in the Virgin Islands, shipped to the U.S., and mixed into cocktails or cordials in the U.S. prior to leaving Internal Revenue bond, even though the excise tax is not collected until the mixed article leaves bonded status.

Schenley's next concern is over cane neutral spirits—a product which is made the same as rum except that it is distilled to a slightly higher proof, 190° or above. Given the close similarity of cane neutral spirits to rum, in terms of raw materials and production, and the fact that cane neutral spirits have not provided the impetus for the proposed change in § 7652 of the Code, we believe there is no reason to distinguish between rum and cane neutral spirits in the legislation—both should be covered by the exception. We would assume, further, that, if cane neutral spirits were included in the paragraph excepting rum from application of the new subsection (c), BATF would treat cane neutral spirits distilled in the Virgin Islands and shipped to the U.S. for mixing in cocktails, liqueurs or cordials in the same manner as it proposes to treat rum so distilled and shipped.

Finally, Schenley is concerned that this legislation not restrict the Virgin Islands ability to receive an excise tax rebate on rum or cane neutral spirits-based liqueurs, cordials, or cocktails mixed in the Virgin Islands and shipped to the U.S. in mixed form. Since mixing and bottling operations are labor intensive, it would be of great aid to the Virgin Islands' fragile economy to preserve the statutory status quo in this regard. Accordingly, we would hope that the Committee would expand the exception to cover not only rum and cane neutral spirits but also liqueurs, cordials and other mixes in which, taking language from the bill, "substantially all" of the distilled spirits therein consisted of rum and/or cane neutral spirits.

People have been distilling sugar cane molasses into rum and other spirits in the Virgin Islands for more than two centuries. I am certain this Committee would not intentionally propose legislation which would unreasonably restrain VIRIL from pursuing legitimate business opportunities involving distillation from sugar cane molasses. As I said at the outset, we believe the Congress can cure any existing problems short of establishing complicated new value added or subsidies tests. But, at a minimum, if the Congress does choose to impose such tests, we hope that the implementing legislation will make crystal clear Congressional intent to exempt from those tests not only rum but also the other molasses-based distilled spirits and mixtures associated with these islands. I would, of course, be pleased to answer any questions which members of the Committee might have at this time and to continue to work with your staff to be certain that everyone fully appreciates the practical impact of the textual formulations under consideration.

Thank you again for this opportunity to present Schenley's views on this matter.

Mr. GIBBONS. Thank you very much.

Are there questions of the panel members today?

Mr. PICKLE. Mr. Chairman, I do not have a question, but I am glad to see our colleague, Mr. de Lugo, here, and Governor Luis, and I hope that they continue to show hospitality to those who visit their great part of our country, and I ask them to pay my respects to Noble Samuel.

Mr. DE LUGO. You may be interested to know that the Park Service has lost the services of Noble Samuel. Our Governor has recently appointed him as administrator for the Island of St. John.

Mr. GIBBONS. Well, we will have to take the administrator with us next time. [General laughter.]

He is a very fine gentleman. Please give him my warm regards. And Governor, and Mr. de Lugo, and Mr. Kraemer, we appreciate your coming and helping us with this.

Mr. RANGEL. Mr. Chairman, I would like to join with my colleagues in welcoming Congressman de Lugo and letting the Governor know that his influence in this Congress is felt far beyond the Ways and Means Committee, sometimes to our embarrassment, but his effectiveness is strongly felt by the leadership. We are lucky to have him here with us.

Thank you, Mr. Chairman.

Mr. STARK. Mr. Chairman, I just wanted to welcome Congressman de Lugo and the Governor and the counsel for the rum industry and, as the author of the legislation which they have testified about, to assure them that we are aware of the Virgin Islands' problems. Congressman de Lugo has been most thorough in briefing our staff, and I am sure that we can accommodate all of the interests of the Virgin Islands which presently are completely legitimate, and we do not intend to change by virtue of this legislation at all.

Thank you, Mr. Chairman.

Mr. GIBBONS. Thank you, gentleman.

Mr. DE LUGO. Mr. Chairman, let me just thank you and the members of this committee for the courtesies you have extended to me time and time again, and for the fact that you have given me a hearing, a fair one, and a lot of your very good friends. Thank you very much

Mr. GIBBONS. Our next witness is the Honorable Baltasar Corrada, who is a Member in Congress from Puerto Rico, and he is accompanied by his Governor also, Gov. Carlos Romero-Barcelo.

Mr. CORRADA. Thank you very much, Mr. Chairman.

Mr. GIBBONS. We will not say as many nice things as we said about your colleague, Mr. de Lugo. We do not lay it on quite as heavy, you understand. We have got a lot to cover today, but both of you gentlemen have a unique position in this Government and this Congress, and both of you carry it out with great distinction, and it helps us understand the unique problems of your area. Also your Governor has always done an excellent job in doing this also, and we are glad to have you here with us again today.

STATEMENT OF HON. BALTASAR CORRADA, RESIDENT COMMISSIONER IN CONGRESS FROM PUERTO RICO

Mr. CORRADA. Thank you very much, Mr. Chairman and members of the committee.

I appreciate the opportunity to appear before you today to testify on H.R. 4702, one of the proposals being considered by the committee. Simply stated, enactment of H.R. 4702 as drafted would abruptly and immediately terminate the program. If such termination is done the way the bill contemplates, it would be disastrous to Puerto Rico and our local economy.

The redistillation program begun in late 1982 is not an abuse. It is not a scam. It was started after discussions by the Puerto Rican Government officials with the Bureau of Alcohol, Tobacco, and Firearms, and rulings were obtained that these could be done within the framework of current law. These discussions led to the issuance of rulings authorizing the rebate to Puerto Rico of excise taxes collected on neutral spirits redistilled in Puerto Rico. The rebate of $10.50 per gallon of distilled spirits is turned over to the Treasury of Puerto Rico under a provision of the U.S. Congress which was first enacted in 1900 and which became section 7652 of the Internal Revenue Code.

Officials of the Government of Puerto Rico and their counsel held extensive meetings and exchanged correspondence with representatives of the Bureau of Alcohol, Tobacco, and Firearms to discuss the program. In reliance on that approval by the Bureau, the program was started. At the local level, the program also obtained the approval of the legislature of Puerto Rico which appropriated funds for incentives to attract companies.

Assistant Secretary Chapoton stated last week in answering a question about this program that there is a question of good faith relieance on the part of the Government of Puerto Rico which justifies a reasonable termination period for the program. I would like to strongly emphasize this point. Based upon the approval we had received for the program, the Government of Puerto Rico has budgeted the money to be received during the balance of fiscal year 1984, which ends on June 30, 1984, and for fiscal year 1985, which begins on July 1, 1984.

The Puerto Rico fiscal year 1984 budget provides for receipt of $166 million for the cane neutral spirits and redistillation program. This figure accounts for 7.3 percent of Puerto Rico's annual operating budget of $2.2 billion. The fiscal year 1985 budget, which has already been submitted to the legislature, projected revenues of $221 million under the two aspects of this program. Should the effective date of the elimination of the program remain January 31, 1984, the date of introduction, the impact on Puerto Rico would be devastating.

In addition, the fiscal year 1985 budget process is already under way in the legislature, and it is imperative that the revenue for that fiscal year be protected.

Another section of the bill would affect the cane neutral spirits portion of the program. This process takes place entirely in Puerto Rico, and there is no doubt that the alcohol obtained is a product of Puerto Rico. However, since Puerto Rico supplements its domestic sugar cane industry with imported molasses for the manufacturing of rum and cane neutral spirits, the 50-percent value added test in the bill would not be met.

I urge you to amend subsection C(5) to also exempt neutral spirits distilled from sugar cane from the provisions of the bill. The funds already received have been used in Puerto Rico to maintain the level of funding for education and health programs.

Mr. Chairman, this is not a program only that helps rum producers or producers of distilled spirits. The revenues derived from this program go to the Puerto Rican treasury. We provide better education and health service to our children, benefits public assistance to our population, and were it not because these funds are provided, then there would be greater dependency on Federal funds to solve many of these social problems.

It may be easy for the Virgin Islands with a population of only 100,000 people instead of 3.2 million as Puerto Rico has to say that they do not care much about these programs. Well, they are not even covered by the Jones Act, and they can ship their rum here in foreign flag vessels, but in Puerto Rico we are covered by the Jones Act. We have to ship in American flag vessels, and we are willing to do so because we believe we have to support the merchant marine.

This program is vital to Puerto Rico, which has been affected by a loss of about $805 million in Federal funds because of cutbacks implemented in the Federal budget for the last 3 years, particularly over $400 million that we have lost in cutbacks in the foodstamp program, over $300 million that we have lost in manpower training programs and job training programs such as CETA, and reductions in housing programs and Farmers Home Administration programs and Economic Development Administration programs as well.

So, my plea to you this morning is, first of all, let us make a distinction between the cane neutral spirit program and the redistillation program. The cane neutral spirit program should be allowed to continue. With reference to the redistillation program, we believe that it is essential that we keep it at least for the balance of this fiscal year and for fiscal year 1985, because these funds are projected in our budget. Perhaps there could be a cap to it and an orderly phase out of the program, so that whatever measure you adopt is equitable both to the U.S. Government as well as to the people of Puerto Rico.

I thank you very much for this opportunity, and of course I am honored to introduce to you a good friend and a man who has been Governor of Puerto Rico since 1977, Gov. Carlos Romero-Barcelo, who joins me this morning.

[The prepared statement follows:]

STATEMENT OF HON. BALTASAR CORRADA, RESIDENT COMMISSIONER, PUERTO RICO

Mr. Chairman, Members of the Committee: I appreciate the opportunity to appear before you today to testify on H.R. 4702, one of the proposals being considered by the Committee.

In the interest of time, I will keep my remarks short.

Simply stated, enactment of H.R. 4702, as drafted, would be disastrous to Puerto Rico and our local economy. The redistillation program begun in late 1982 was started after discussions by Puerto Rican government officials, with the Bureau of Alcohol, Tobacco and Firearms (BATF) of the U.S. Department of the Treasury. These discussions led to the issuance of regulations authorizing the rebate to Puerto Rico to excise taxes collected on the neutral spirits redistilled in Puerto Rico. The rebate of $10.50 per gallon of distilled spirits is covered over to the Treasury of Puerto Rico under a provision of the U.S. Congress which was first enacted in 1900 and which became Section 7652 of the Internal Revenue Code of 1954.

Officials of the government of Puerto Rico and their counsel held extensive meetings and exchanged correspondence with representatives of the Bureau of Alcohol, Tobacco and Firearms to discuss the program. In reliance of that approval by the Bureau, the program was begun. At the local level, the program also obtained the approval of the Legislature of Puerto Rico which appropriated funds for incentives to attract companies.

Assistant Secretary Chapoton stated last week in answering a question about this program, there is a question of good faith reliance on the part of the government of Puerto Rico which justifies a reasonable termination period for the program. I would like to strongly emphasize this point. Based on the approval we had received for the program, the government of Puerto Rico has budgeted the money to be received during the balance of Fiscal Year 1984, which ends on June 30, 1984 and for Fiscal Year 1985 which begins on July 1, 1984. The Constitution of Puerto Rico mandates a balanced budget which includes a year end accounting and a prohibition against a deficit.

The Puerto Rico FY 84 budget provides for receipts of $166 million for the cane neutral spirits and redistillation program. This figure accounts for 7.3 percent of Puerto Rico's annual operating budget of $2.2 billion. The FY 85 budget which has already been submitted to the Legislature, projected revenues of $221 million. Should the effective date of elimination of the program remain January 31, 1984, the date of introduction, the impact on Puerto Rico would be devastating. In addition, the FY 85 budget process is already underway in the Legislature and it is imperative that the revenue for that fiscal year be protected. Another section of the bill would affect the cane neutral spirits portion of the program. This process takes place entirely in Puerto Rico and there is no doubt that the alcohol obtained is a product of Puerto Rico. However, since Puerto Rico supplements its domestic sugarcane industry with imported molasses for the manufacturing of rum and cane neutral spirits, the 50 percent value added test in the bill would not be met. I urge you to amend subsection (c)(5) to also exempt neutral spirits distilled from cane from the provisions of the bill.

The funds already received have been used in Puerto Rico to maintain the level of funding for education and health programs which suffered the deepest cuts during 1981 and 1982 recession. If it is the Congress' decision that this program should be terminated, it is only fair and just that the effective date for the termination take into account the good faith reliance of Puerto Rico on these revenues. I urge the Committee to revise the effective date to the end of Fiscal Year 1985—either in Puerto Rico which is June 30, 1985 or the federal fiscal year which ends September 30, 1985. In order to ensure that the program will not grow any further, a cap could be placed. I suggest that the cap should be the $221 million projected figure for FY 85.

I am hopeful that the committee will exercise its good judgement to ensure that their fellow citizens residing in Puerto Rico are not adversely affected by the abrupt termination of the program. Mr. Chairman, I look forward to working with you and the members of the Committee in achieving a mutually satisfying solution.

Mr. **Gibbons**. Governor, we are glad to have you here. You may proceed as you wish.

STATEMENT OF HON. CARLOS ROMERO-BARCELO, GOVERNOR OF PUERTO RICO, ACCOMPANIED BY JOSE COBIAN, PRESIDENT, PUERTO RICAN INDUSTRIAL DEVELOPMENT CO.

Mr. **Romero-Barcelo**. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee. I am here for the second time in less than 2 years, hurrying through the Halls of Congress, concerned about an action by Congress, where we have no representation and no votes—we have representation, very, very adequte representation by Mr. Baltasar Corrado, but he lacks the vote on the floor, and we do not have the proportional representation which the States do.

Mr. **Corrada**. I know what you mean quite well, Governor.

Mr. **Romero-Barcelo**. This act of Congress is going to affect us deeply without our having an effective vote or voice in this act of Congress, and I am deeply concerned, because in 1982 our section 936, which applies to the taxing of revenues by possession corporations including Puerto Rico, was going to be amended in such a way that it could have affected, very seriously affected the program. Had it not been for Congressman Rangel, who on the 12th hour stopped a very unfavorable amendment, we would have perhaps been in a worse problem than we are now with 23 percent unemployment.

Fortunately, section 936 was saved, and the regulations that have been adopted have been agreeable to the Treasury and agreeable to the White House and agreeable to the Congress, and seem to be agreeable to everyone, so we are very happy with that.

Now, here again we are faced with an action, a proposed action by Congress which would affect us very, very adversely, which would take away for next year $221 million of revenues which the people of Puerto Rico severely need. We do not receive the same participation in educational funds that the States do, we receive barely $45 million for medicaid—which is less than $25 per inhabitant, when the rest of the Nation receives in medicaid over $500 per inhabitant—and yet we are required by Federal law to meet the Federal standards in medical health and care, and as we are required also by Federal law to meet the requirements in the prisons for the facilities for our prisoners, even though the per capita income of Puerto Rico is 57 percent that of Mississippi, which is the poorest State in the Nation.

All of a sudden it seems that actions by the Congress and the Executive are focusing in on Puerto Rico and trying to solve part of the national deficit by taking money away from Puerto Rico. How unfair can that be, when we have such—we have the highest unemployment in the Nation. We at this point have 23 percent unemployment, and if $221 million were to be taken away from us for next year, and the other part of our budget from this year, as the bill is proposed, beginning February 1 until June 30, which is the end of our fiscal year, that would mean we would have to take it away from those two items in our budget which are the largest, which are education and health, where we do not participate fully as the States do in all of the programs that benefit the States in education and health.

I think this would be extremely unfair. One of the things that had been talked about is that this is an "abuse," and I want to make a strong objection to the words here by my colleague, the Governor of the Virgin Islands. "Abuse" in the Webster New International Dictionary means "a corrupt practice or custom." What we are doing is with an agreement with the Bureau of Alcohol, Tobacco and Firearms. We went with them through every step of the process, and it was cleared by the Bureau. Even when we started and there were some doubts, we stopped the program for 3 months to further clear it with the Bureau. I think those words are extremely unfounded. The Virgin Islands just is not subject to the Jones Act. We are, and we do not complain about the fact that they have a privilege which we do not have.

But I wanted to mention that were this bill to be passed as it is, the means of producing revenue which was the result of the shortchanging that Puerto Rico received in the past few years would be stricken away at the stroke of a pen, and here we would be affected in this budget. We would have then a deficit budget in 1984. Our constitution does not allow us to have a deficit budget. We would have then for 1984-85 $221 million less. I do not see how we could come up with a balanced budget in 1984-85. I do not think we are going to have a budget in Puerto Rico, as a matter of fact, because of the political situation where the House and the Senate are controlled by the opposition parties, and we probably will have to go on with the same budget that we have this year, but then we would still not have the revenue.

So the situation is extremely serious, and I think that the least that should be allowed here is that we would have this year allowed completely, next year also, the fiscal year 1984-85, and then have a phaseout of the program. We went into this in good faith. We went into this with an agreement with the Bureau of Alcohol, Tobacco and Firearms, and to take these revenues now from the government of Puerto Rico to try to solve the deficit problem of the Nation, which is $200 billion, I think is extremely unfair.

We want to make it clear that were this to go through, the unemployment in Puerto Rico would worsen, as would our educational services which are so important now—and the president has called for an allout effort to improve education. We are striving toward excellence in education, but all of those programs we have now for next year would completely be wiped out. We could not carry them on. It is necessary that we educate our people so that we can provide them with jobs and induce industry to come to Puerto Rico, so that we have a labor force that is duly trained and duly educated. If that were to be stricken and taken away from us, I think it would be extremely, extremely unfair. To try to solve the deficit problems of the Nation with the poorest territory, on a per capita basis, in the Nation and the poorest State or territory is extremely, extremely unfair. I do not know how more strongly to express my opposition or how more vociferously or positively to explain my position than I have. I thank you so very much for having given me the opportunity to explain the position that we are in, and do hope that we can come to some kind of terms where the blow, the eventual blow, will be at least diminished by a phaseout beyond the fiscal year 1984-85. Thank you.

[The prepared statement follows:]

STATEMENT OF HON. CARLOS ROMERO-BARCELO, GOVERNOR OF PUERTO RICO

My name is Carlos Romero-Barcelo, and since 1977 I have been Governor of Puerto Rico.

I come before you today to express the serious concern of the Government of Puerto Rico with respect to H.R. 4702, a bill which would amend section 7652 of the Internal Revenue Code of 1954. If enacted in its present form, H.R. 4702 would cause severe hardship to the people of Puerto Rico. This hardship would result directly from the bill's extraordinarily adverse impact on our distilled spirits industry and on the financial condition of the Puerto Rican Government.

Under a statute first enacted in 1900, and currently embodied in section 7642 of the Internal Revenue Code, Puerto Rico products transported to the mainland are taxed at the same rate as mainland products; however, the tax collected on Puerto Rico products is covered into the treasury of Puerto Rico. The principal product of Puerto Rico currently subject to taxation and cover-over under section 7652, is distilled spirits. Puerto Rico's government budget, for the fiscal year ending June 30, 1984, anticipates the receipt of $232-million from the transfer to the Island of the U.S. excise tax on Puerto Rican rum that is shipped to the mainland for consumption or sale. In part to safeguard this traditional and very essential revenue source, we created in 1982 an incentive program for the production of non-rum distilled spirits. This program was initiated after we had obtained from the U.S. Treasury Bureau of Alcohol, Tobacco and Firearms (ATF) a series of rulings concerning the circumstances under which spirits would be considered to have been "produced in Puerto Rico" within the meaning of the pertinent Federal statute.

A combination of factors prompted us to establish this incentive program. And it is important to keep in mind that each of those factors involved Federal government actions which adversely affected the economic well-being of Puerto Rico, and the more than three million U.S. citizens to who reside there. With the change in 1980 to the proof gallon method of taxing distilled spirits, the federal excise tax on competing Caribbean rums was reduced. In addition, under the General Agreement on Tariffs and Trade (GATT), the duty on imported rum was reduced with further reductions scheduled to be phased in through 1987. The immediate consequence of these two changes was a reduction in the cost of Caribbean rums on the mainland of $8.19 per case, and this in turn brought stiffer competition as new Caribbean rums entered the market. This had an advese impact on the distilled spirits industry in Puerto Rico. In fact, before the distilled spirits program was begun, Destileria Serralles, a major producer of distilled spirits on the Island, was utilizing only 50% of its production capacity and was facing a real danger of bankruptcy.

When the administration assumed office, the cutback in Federal social programs which began in 1981, reduced very substantially the funds allocated to Puerto Rico for such programs as CETA, Food Stamps, and federal construction projects. We estimate that as a result of federal program cuts, we have lost over $800 million in federal appropriations over the past three years. The problem for Puerto Rico was compounded by world-wide recession, new federal tax breaks (such as ACRS) which were not made available to business on the Island, and uncertainty surrounding the operation of section 936 of the Internal Revenue Code, making it increasingly difficult to promote the new industry and generate new jobs in Puerto Rico, where unemployment has been running well in excess of 20%.

Almost out of desperation, we made a complete review of the entire liquor industry in Puerto Rico. The obvious conclusion was that, both for the sake of the industry and the Government's revenues, it was necessary to expand the product base so as not to depend exclusively on rums. We were particularly concerned about the possibility of Serralles' failure, which would result in a loss of several hundred jobs, plus a potential loss of revenues to the Government of Puerto Rico of nearly 30 million dollars annually. To accomplish diversification in the industry, we developed a program for the production of neutral distilled spirits, designed after the "Rums of Puerto Rico" program which had been so successful through granting of incentives in the form of advertising and tax exemptions in developing Puerto Rican rum production. We planned to bring about a substantial level of neutral distilled spirits production, but not more than that of rum. The revenues produced under the program were to be allocated to the development of the infrastructure necessary to support increased industrial activity on the Island—to improve roads, water and electric utilities, etc.

In 1976, the Government of Puerto Rico began to explore with the Bureau of Alcohol, Tobacco and Firearms what distilled spirits operations in Puerto Rico would result in products "produced in Puerto Rico" and qualify for the tax transfer to Puerto Rico. For example, in 1976 ATF ruled in a letter to the Puerto Rican Government that rum, vodka or gin produced in the U.S. and rectified in Puerto Rico would be consideredc products of Puerto Rico under section 7652, with the result that the tax imposed thereon would be covered into the treasury of Puerto Rico. (The ruling specifically noted that redistillation included the term "rectification.") In May 1976 ATF ruled that if straight whisky (such as bourbon whisky, produced on the mainland) were mixed in Puerto Rico with 80% (on a proof gallon basis) of less of neutral spirits distilled in Puerto Rico, the resulting "blended whisky" would be a product of Puerto Rico. In response to other inquiries by the Government of Puerto Rico, a series of other AFT rulings—the principal ones of which I will mention—followed in 1981, 1982, and 1983.

In reliance on this series of rulings, in 1982 the Economic Development Administration, also known as Fomento, launched an incentive program for production of neutral distilled spirits. The distilled spirits operations covered by the program were fully disclosed to ATF in Puerto Rico's various ruling requests, and no part of the program was implemented without ATF's ruling that the resulting spirits would qualify as a product of Puerto Rico. The U.S. Treasury has had effective control over the program since its initiation because Treasury collects the exise tax and pays it over to Puerto Rico.

Fomento solicited from the Legislature of Puerto Rico authority to grant an industrial incentive up to a specified dollar amount for the production of distilled spirits under the program. (For the fiscal years 1983-84, the Legislature approved an incentive of up to $2 per proof gallon, to a maximum accumulated total of $30 million.) When this authority has been granted, Fomento contacted Puerto Rican distilleries and informed them that incentives were available for the manufacturing of neutral spirits in Puerto Rico. The Island distilleries, after locating customers for the spirits on the mainland, approached the Economic Development Administration and executed incentive contracts.

One part of the program provides an incentive for the production of cane neutral spirits; these spirits are produced from molasses and are originally and wholly distilled in Puerto Rico, then shipped to the mainland to be mixed with flavorings and colorings to produce cordials, liqueurs and cocktails. Under a ruling issued by ATF in June 1981, the tax on such cordials, liqueurs and cocktails qualifies to be covered into the Treasury of Puerto Rico to the extent of the base Puerto Rican spirits in the end product, exclusive of other alcoholic materials used in the mixing process on the mainland. Puerto Rico Distillers, a subsidiary of Seagrams, and Bacardi Corporation currently produce cane neutral spirits in Puerto Rico under the program and receive an incentive of 50 cents per gallon from Fomento, plus approximately $1 per gallon for transportation to the mainland and other costs.

The other part of the program involves the redistillation in Puerto Rico of light whisky, originally distilled on the mainland, to produce neutral spirits or vodka. These spirits are then shipped back to the mainland for bottling and sale, principally as vodka. ATF has advised representatives of Fomento, and confirmed in an April 1983 ruling to a mainland distilled spirits company, that such redistilled neutral spirits would qualify for the tax transfer as a product of Puerto Rico. The principal participant in this facet of the program is Destileria Serralles, a Puerto Rican family-owned distillery, which provides redistilled spirts to Heublein spirits (distributor for Serralles' "Don Q Rum") and to Distiller Co., Ltd. The other participant in the redistillation program is F.T.G. Corporation, a joint venture of Trigo Hermanos, Inc. (a family-owned Puerto Rico distillery) and Glenmore Distilleries Co., which has invested over $1 million in new plant and equipment to provide neutral spirits to Glenmore. Both Serralles and F.T.G. receive a 50 cent per gallon incentive from Fomento.

In addition, to make it possible for the Puerto Rican distillers to be competitive with mainland distillers. Fomento reimburses them for the marginal increase in costs attributable to redistillation in Puerto Rico, i.e., the amount by which the costs of transportation, electricity, insurance, etc. exceed the costs which would have been incurred if the spirits had been redistilled on the mainland. In the case of F.T.G., the reimbursed cost equals $1.35 per gallon; Serralles receives $1.49 per gallon for additional costs under its current contract with Fomento these amounts are paid from Fomento's distilled spirits program appropriation when the spirits are shipped from Puerto Rico. The U.S. excise on such spirits normally does not come to Puerto Rico until 60 to 90 days later and is paid directly to the treasury of Puerto Rico, not to Fomento or to the distillers. Nothing is paid to the mainland spirits company by Fomento or any other Puerto Rican government agency.

We have heard allegations that under the distilled spirits program Puerto Rico pays the bulk of the $10.50 per gallon excise tax to the U.S. spirits companies and that they in turn have undercut their competition by as much as $3 per bottle! These allegations are simply untrue. As I have just stated, we pay an incentive to the Puerto Rican distiller of at most 2 dollars per gallon, the major portion of which reimburses the distiller for the added costs of producing the spirits in Puerto Rico—principally transportation and electricity—to put them on a competitive footing with mainland distillers. Only the 50 cent payment could affect the Puerto Rican distiller's gross profit margin, and even if the entire 50 cents were passed through to the mainland spirits company, either through a direct payment, a price adjustment, or some other credit, the profit to the mainland company would at most be 7 cents per 750 ml bottle of 80 proof spirits.

The Government of Puerto Rico has relied on the ATF rulings which provide that the spirits produced under the program qualify for the transfer of excise taxes to Puerto Rico and has induced distilled spirits companies to invest in new plant and equipment in Puerto Rico. The Government has also relied on the rulings in preparing its budget. For the current fiscal year, which ends June 30, 1984, Puerto Rico has budgeted receipts of $36 million from the tax on Puerto Rican cane neutral spirits shipped to the mainland; this represents 1.3% of the Island's approximately $2.2 billion operating budget for the current year.

Puerto Rico has budgeted receipts of $130 million for FYE 1984 from the tax on redistilled spirits, or 6.0% of its operating budget. (The tax on Puerto Rican rum for the year is budgeted at $232 million, or 10.5% of the budget.) The budget for fiscal year ending 1985, which has already been submitted to the legislature for approval, projects $221 million from spirits under the program, and $240 million from rum. I should point out that under Puerto Rico's Constitution a balanced budget is required and no year-end deficit is permitted.

H.R. 4702 would abruptly reverse the interpretations of section 7652 made to Puerto Rico by ATF now in effect and cut off the payment to the Island of excise taxes on redistilled spirits and cane neutral spirits produced under the program, effective for spirits brought into the mainland U.S. on or after January 31, 1984, the day of introduction of H.R. 4702.

Whatever policy considerations might suggest that redistilled spirits not be treated as a product of Puerto Rico under section 7652, there is no sound policy reason why the tax on cane neutral spirits distilled wholly on the Island should not qualify for cover-over to the treasury of Puerto Rico. The bill would amend section 7652 by adding a new subsection (c) imposing three separate requirements with respect to articles produced in Puerto Rico, any one of which would disqualify redistilled spirits and at least two of which would probably disqualify cane neutral spirits. We believe that under the first requirement, that substantially all of the distilled spirits in an article must be originally distilled in Puerto Rico, the cordials, liqueurs and cocktails made with cane neutral spirits would qualify as a product of Puerto Rico because of the small portion of non-Puerto Rican alcohol in the colorings and flavorings blended to produce them. Nevertheless, since the meaning of "substantially all" may be subject to varying interpretations, we believe it should be clarified to guarantee the continued qualifications of cane neutral spirits.

Cane neutral spirits cannot meet the second requirement under the bill, that 50% of the value of the spirits coming into the mainland must have been added in Puerto Rico. Furthermore, the third requirement is too restrictive and could not be met. It would prohibit transfer of excise tax to Puerto Rico on any article for which Puerto Rico provides and "excise tax subsidy," defined as a subsidy (1) of a kind different from, or (2) in an amount per value or volume of production greater than, that provided with respect to articles not subject to federal excise tax. Puerto Rico provides industry with many different kinds of incentives which may vary according to the type of industry, its location, its capital investment, and the length of time that it has been on the Island. The incentive for the production of cane neutral spirits, for example, is unique to the distilled spirits industry and is "of a kind different from" that granted other industry, and would thus be proscribed under the bill.

H.R. 7402 would exempt rum from all three of the restrictions which I have described. Since cane neutral spirits produced under the program are wholly and originally distilled in Puerto Rico through a process similar to that for producing rum, they should receive the same treatment as rum. This could be accomplished by expanding the exception in subsection (c)(5) to include rum and neutral spirits distilled from cane. As an alternative, the value-added and excise tax subsidy provisions could be deleted. Either change would accomplish the necessary and, we believe, justifiable exclusion of cane neutral spirits from the restrictive effect of the bill.

The most serious problem with the bill is that the January 31 effective date would throw the Government of Puerto Rico into a fiscal crisis. As I have said, the tax on spirits produced under the distilled spirits incentive program amounts to 7.3% of Puerto Rico's operating budget for the current fiscal year ending June 30, 1984, and even more in the budget for fiscal year 1985, which has already been sent to the legislature for approval. Because of the balanced budget requirement of Puerto Rico's constitution, the revenue short-fall caused by H.R. 4702 would have to be offset by Puerto Rico. It would be impossible to cover such a short fall through increased taxes in the few months remaining in this fiscal year.

To allow Puerto Rico to make required fiscal adjustments, the effective date should be delayed, and a suitable phase-in period to allow an orderly transition should not begin at least until after the close of fiscal year 1985. In the meantime, in order to allay fears of increasing revenue loss to the U.S. and to coordinate with the cap imposed on the program by the Puerto Rican Legislature's appropriation for the incentive, a cap could be placed on taxes transferred to Puerto Rico with respect to spirits not substantially all of which were distilled on the Island.

Mr. GIBBONS. Governor, let me tell you one thing. I am speaking now only for one member. As far as I am concerned, Puerto Rico can be anything it wants to. If you want to be independent, just let this member know. I will be happy to——

Mr. ROMERO-BARCELO. No, sir. I want to be a State.

Mr. GIBBONS. Wait a minute. I have the floor now. If you want to be a State, let us know. If you want to be just like you are, let us know. But I think you ought to know, and I am telling you directly, we are not picking on Puerto Rico, and never come here saying that. You can come here just like anybody else and give us hell for anything we do wrong, but do not come here saying we are picking on Puerto Rico. We are not trying to balance the budget on the backs of the Puerto Ricans. We are trying to do justice under the tax system, and that is all. So as far as I am concerned, Puerto Rico can be independent, it can be a State, it can be the present thing, or it can be anything it wants to be, but just let us know what you want.

Now, your Representative here in Congress is a very effective representative, and we have paid a lot of attention to him. I want to tell you, I have paid more attention to him than I pay to most of the other Members of Congress around here because of the unique status that Puerto Rico has, and I have a great deal of sympathy for it.

Now, I am sorry that the problems of Puerto Rico get mixed up in the problems of the United States, but as far as I am concerned, you can have anything you want to down there in Puerto Rico, complete, total independence right now or tomorrow if you want it, but we are doing the best we can in a very difficult situation, and I resent the fact that you come here and say we are picking on Puerto Rico. We are not picking on Puerto Rico. We never intend to pick on Puerto Rico. There is not a Member of this Congress that intends to pick on Puerto Rico, Governor.

Now, do any of my colleagues have questions?

Mr. **Romero-Barcelo**. Mr. Chairman, may I please say something?

Mr. **Gibbons**. Yes, sir.

Mr. **Romero-Barcelo**. Mr. Chairman, I did not say that you are picking on Puerto Rico. I said Puerto Rico has been—twice in the last 2 years acts of this Congress were about to affect Puerto Rico very, very seriously, and because we do not have that participation, it creates a very great sense of frustration.

Mr. **Gibbons**. I know it creates a sense of frustration, Governor, but I do not want you going out of this chamber and I do not want your message to go out of this chamber that we are picking on Puerto Rico. We do the best we can by Puerto Rico, and as far as this one Member is concerned, you and Puerto Rico can have anything you want, statehood, independence, or the status you have got, or any other status you can think up.

But we have to collect taxes in this country to run this country, and as I have said before, I pay more attention to the Delegate from Puerto Rico than I do to my other colleagues in the 50 States of the United States, because of the unique status, and I think every Member of this Congress leans over backwards because of that.

We are perplexed, just like you are perplexed about the situation, but do not come here accusing us of being unfair to Puerto Rico. We do not intend to be. If we do anything, it is by accident, and we try to straighten it out.

Mr. **Rangel**. Mr. Chairman.

Chairman **Rostenkowski**. Mr. Rangel will inquire.

Mr. **Rangel**. One of the problems we have in the Congress, Mr. Governor, is that not all of Members have the sophistication or the broad understanding of international problems as the chairman of the Trade Subcommittee, Mr. Gibbons. I would dare say that as desperately hard as we try to be fair to all of our citizens, there are many Members of Congress who are unware of the fact that Puerto Rico does enjoy U.S. citizenship.

At least when we had the 936 dispute brought to the floor of the Congress, there were many Members, and I do recall even one member of this committee, indicating some doubts about Puerto Rican citizenship.

I appreciate the fact that you gave me credit in stopping what appeared to be a piece of legislation that could have adversely affected the economy of Puerto Rico. I want to make it abundantly clear that it was the chairman of this committee who understood that the people of Puerto Rico were looking for equity and they were only asking that if there was abuse involved in that legislation, then at least we should have hearings so that the people and the business people who invest in Puerto Rico would have the opportunity to come forward and explain their posture. That was done, and I do not think it should have been done any other way.

Now it appears to me that there is some question from Members of Congress as to whether there is an abuse in another tax program. Most of these tax programs are designed to substitute the independence of the Puerto Rican people for direct grant legislation, which, as you eloquently pointed out, is denied to the citizens on a per capita basis when it is not denied to citizens on the mainland.

It would appear to me that if the Secretary of Treasury is fully aware of this program, and if discussions occurred with the Bureau of Alcohol, Tobacco, and Firearms, and if in fact the government of Puerto Rico has relied on these revenues as a part of their budget within the framework of existing law, then you come here once again not asking so much that the Congress does not change the law, but if it does not deny to the people of Puerto Rico due process, whether it is 936 or existing legislation.

I have been assured by Mr. Chapoton of this administration that whatever problems they may have with existing law, that in all fairness to those of you that have to depend on a balanced budget, that the Congress should take that into consideration, and that by regulation things could be worked out for an equitable phaseout. It would seem to me that you should have every right to ask the U.S. Government that if revenues are going to be denied from one area, then how could they be supplemented to make certain that all of our citizens are treated equally.

I think that it is sometimes embarrassing for American citizens to have to come to the U.S. Congress and have a different type of law, some less equitable than others, apply to those citizens. You have to understand that we have a long history in the United States that sometimes those people who speak differently from the general population are treated differently. It is not done with a lot of malice and forethought, but sometimes lack of understanding on the part of the members has sometimes been reflected in legislation.

But as Mr. Gibbons has said, there is a desire on the part of all members of this committee to treat Puerto Rico fairly and equitably, and I am convinced that your testimony is well received by all of the members of this committee.

Thank you, Mr. Chairman.

Chairman Rostenkowski. Thank you, Mr. Rangel.

Mr. Stark will inquire.

Mr. Stark. Thank you, Mr. Chairman.

I am sorry that this legislation appears to be picking on Puerto Rico, but I would just like to state for the record that my colleague from New York's suggestion of an equitable phaseout is something that I am sure the staff of that subcommittee which helped draft this legislation is willing to look at, but I also believe that there are two facts that ought to be clarified at this point.

One is that in defense of the Bureau of Alcohol, Tobacco and Firearms, they did request information from the government of Puerto Rico as to the amount and the extent of the rebate program, the $2 a gallon which is returned to the distillers, and that request was never answered until after this legislation was introduced. Is that not correct, Governor?

Mr. Romero-Barcelo. I am not aware of that, Mr. Stark.

Mr. **Stark**. Well, I am, and if you have any letters responding to the BATF request for information prior to this legislation, I think they should appear in the record, because there was not, absent that information, complete disclosure to BATF.

Mr. **Romero-Barcelo**. I will look into that, Mr. Stark.

[The following was subsequently received:]

Hamel & Park,
Washington, D.C., March 21, 1984.

John J. Salmon, Esquire,
Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Longworth Building, Washington, D.C.

Dear Mr. Salmon. Enclosed is the transcript of Governor Carlos Romero-Barcelo's testimony, marked with the necessary corrections.

Because of our participation as counsel to the Government of Puerto Rico in discussions with the Bureau of Alcohol, Tobacco and Firearms concerning Puerto Rico's distilled spirits program, Governor Romero has asked us to respond to a question asked by Congressman Stark at the hearing (page 42 of the enclosed transcript) which the Governor was unable to answer at that time, Mr. Stark stated that the Bureau of Alcohol, Tobacco and Firearms had requested information from the Government of Puerto Rico as to the amount and extent of the redistillation rebate program and that "that request was never answered until after this legislation was introduced." When the Governor stated in response that he was not aware of that request, he was asked to submit for the record any responses that were made to the BATF request. This letter is accordingly submitted for the record to be attached to the Governor's testimony.

Mr. Stark apparently has reference to a sentence in a letter which BATF addressed to Mr. John R. Newton, Assistant Secretary of Economic Affairs in the Department of the Treasury of Puerto Rico on January 3, 1983, in which Mr. Newton was requested to furnish information such as that described by Mr. Stark. It should be noted, however, that the BATF letter was concerned almost entirely with the nature of the redistillation process, with the nature of the material shipped to Puerto Rico from the United States, and with the identity of the product leaving Puerto Rico, in order to enable the Bureau to determine whether as a legal matter Puerto Rico's "incentives program qualifies for the tax under the provisions of 26 U.S.C. 7652." Mr. Newton responded that because the administration of the program was the responsibility of EDA (the Puerto Rico Economic Development Administration), the Treasury of Puerto Rico had "referred your inquiry to them." At the request of EDA, we then asked for a conference with officials of BATF for the purpose of furnishing BATF with a full explanation of the program and why we believed that the ensuing product qualified under the statute for "cover over" of the applicable taxes to Puerto Rico.

We appeared for such conference with BATF on March 22, 1983. We stated specifically at that time that we were there as a result of the mailing of BATF's January 3, 1983 letter. We met for several hours, describing the program, explaining the authorities on which we relied and responding to numerous questions by the BATF representatives. At no time during that conference did the BATF representatives renew their request for any of the information referred to by Mr. Stark, and we assumed that they had obtained all of the information that they deemed necessary to reach a conclusion on the issue.

There were subsequent discussions with BATF representatives and an exchange of correspondence between BATF and some of the individual distilleries involved, but we were not privy to all of that correspondence and were advised by BATF that because of the restrictions on confidentiality of correspondence with individual taxpayers, they could not furnish us with copies of such correspondence. We did, however, obtain from the Heublein Spirits Group a subsequent letter addressed to Heublein from BATF on April 11, 1983, stating that the BATF would recognize "redistillation of light whisky designate in Puerto Rico" as qualifying as "products of Puerto Rico for tax purposes under the provisions of U.S.C. 7652 when returned to the United States," subject to the fulfillment of certain specific conditions outlined therein. Except for imposing such conditions—all of which were acceptable to Heublein, the Puerto Rican distillery involved and the Government of Puerto Rico—this letter restated the ruling position reflected in prior rulings by BATF to the Government of Puerto Rico since 1976.

It is particularly signficant to note that the ruling of April 1983, on which since that date both the Government of Puerto Rico and the distilleries have relied, and which BATF since that date has followed, was issued without renewal of the request contained in the sentence of the letter of January 3, 1983, to which Mr. Stark referred at the time of the Governor's testimony. We think it may therefore be concluded that we were correct in assuming, following our conference on March 22, 1983, that BATF did not consider the information referred to by Mr. Stark as significant in arriving at its conclusion that the program qualified under section 7652.

K. MARTIN WORTHY,
Counsel for the Government of Puerto Rico.

Mr. STARK. Second, it is my understanding that only two distilleries or two corporations benefit from this particular program, and that others applied and were turned down. Is that not correct?

Mr. ROMERO-BARCELO. I do not think it is any application process. I think the industry does it on its own. I have my staff people here. They can clarify that.

Mr. COBIAN. My name is Jose Cobian. I am president of Puerto Rican Industrial Development Co. Good morning, Mr. Chairman and distinguished members.

Mr. ROMERO-BARCELO. Mr. Stark, would it be all right for him to answer the question, because he would have the facts.

Mr. STARK. Please.

Mr. COBIAN. Yes, the government per se does not get involved in any negotiations with any other American companies from the mainland. We have done this program for the Puerto Rican distillers, and we have negotiated with them an incentive program.

Mr. STARK. Do you have any limits on who can participate in the program?

Mr. COBIAN. Well, we have a limit, sir, because we went to the legislature in Puerto Rico, and we asked for the moneys to be given for this incentive program, and that per se limits us from having anybody else.

Mr. STARK. Well, let me rephrase. It is my understanding that other distilleries applied to participate in this program, and were unable to. Is that a reasonable assumption?

Mr. COBIAN. Yes, there have been some people that have wanted to come into the program, but because we did not have the funds available we could not include them.

Mr. STARK. Thank you.

Mr. ROMERO-BARCELO. Let me clarify that statement. What it means is that the legislature authorizes the funds for the helping of the companies by giving the incentives, and that amount is limited by the authorization, the legislative authorization.

Mr. STARK. How much did you budget for this entire program, Governor?

Mr. COBIAN. For this year, sir, it is $166 million gross and $221 million for the next fiscal year for revenues.

Mr. STARK. And how much have you recieved this year?

Mr. COBIAN. Up to February, we had received around $60 million, sir.

Mr. STARK. Thank you.

Chairman ROSTENKOWSKI. Mrs. Kennelly will inquire.

Mrs. KENNELLY. Representative Corrada, thank you very much for your testimony. I think it helps set the record straight that Puerto Rico did deal extensively with Bureau of Alcohol, Tobacco and Firearms, when setting up the program, and I thank you for helping establish that fact.

I would like to tell the Governor that Assistant Secretary for Tax Policy, Mr. John Chapoton, was here the other day, and I asked the question about full disclosure, and he seemed to accept that there was disclosure. I would have to say to the gentleman from California that the Treasury did approve this program, so I think that area——

Mr. STARK. Would the gentlelady yield?

Mrs. KENNELLY. Certainly.

Mr. STARK. In defense of the Treasury, we just confirmed this in the past 10 minutes with the chief counsel of the BATF: Not only did BATF request information on the rebates which was never provided, but they sent an inspector to Puerto Rico to try to determine, and he was unable to get the information. It really does not make a great deal of difference except I gather—and I am not a lawyer, but I gather there is sort of a clean hands thing, and while nobody intends to punish anyone, and while there certainly is a law that provides this tax procedure to go on, if one has not been available to any manufacturer, and second, that there were some questions as to the scope of the program, and how the rebates would be used, and how much rebate would be there. That is not really relevant to the legislation at this point, but I think for the bureaucrats who work hard, whether they work for Puerto Rico or for the Treasury, it is important that they try to do their job.

Mrs. KENNELLY. Thank you, Mr. Stark.

The point I was trying to bring out, though, Mr. Stark, was that we are getting into fairness, and I think Mr. Corrada's testimony brings out the fact that everyone involved thought the program was carried out according to the law, and they went ahead. We do have a deficit problem, and we have got to face it. But we want to be fair and give some time for adjustments.

So I would just tell the Governor that I did think Mr. Chapoton was aware that there is a need for adjustment time.

Chairman ROSTENKOWSKI. Are there any further questions?

[No response.]

Chairman ROSTENKOWSKI. Governor, I am sorry that I was not here when you presented your testimony. However, I assure you that I will read it. I appreciate your testifying today and the views that you have presented. Your representative here in Washington is a very close friend of this committee and always has been.

There being no further questions, thank you very much.

Mr. CORRADA. Mr. Chairman, let me ask formally that the entire testimony of the Governor appear in the record.

Chairman ROSTENKOWSKI. Without objection, the entire statement will be included in the record.

Mr. CORRADA. I would like to make this remark: Sam Gibbons and I have been close friends because every time I knock at his door, whatever problem we have, he has been sensitive to our issues. At times we may differ on our socioeconomic views, but that is all right; our 435 Members of the House do differ on that, too.

But I know he is well-intended, and I am assured that when we say that this issue may have an adverse impact on Pureto Rico, or whatever, we are not imputing that this is your doing or Pete Stark's doing or any member of this committee's doing.

That would be the effect, the outcome of it, but we are not imputing any type of personal motivation or official motivation to you or any other member of this committee.

Mr. ROMERO-BARCELO. May I, Mr. Chairman, add that posit? Mr. Gibbons, I certainly did not mean to say that you or any member of this committee did purposely, or with any malice, try to pick on Puerto Rico. If my words carried that meaning, Mr. Gibbons, it is because of the frustration that we have suffered because of things that have been happening in the economic situation, and because all of a sudden we are met with this, which would create a real devastation in Puerto Rico as far as our economic resources.

As I said, the education and health of Puerto Ricans would have to suffer, and it is perhaps the result of an impassioned plea of the moment that my words were misconstrued or my words were said in a way that could lend themselves to be interpreted that way. And I request that you forego whatever I said.

Mr. GIBBONS. Governor, I can understand the frustration of your position.

Mr. RANGEL. Mr. Chairman, I would just like to point out that it has been my experience that we respond to people that can vote for or against us, a lot quicker than we do to citizens that can't vote.

While this is not true of members of this committee, it is a political reality. I hope that you understand that when we do have to raise funds. There is a tendency to raise it where it has the least political flack.

So I thank you for coming and explaining what the impact of this legislation would have on our citizens that might not be able to vote for us, but certainly that we have an obligation to protect.

Chairman ROSTENKOWSKI. Thank you very much.

The Chair calls Messrs. Ellentuck, Padwe, Peiliero, Berenson, and Rosenthal.

Welcome to the committee, gentlemen. We look forward to your testimony. I want to counsel you again to try to stay within the 5-minute rule. If your statements are more lengthy than 5 minutes, I suggest that you summarize them. However, your entire statement will be included in the record.

Mr. Ellentuck, if you will proceed, the committee is prepared for your testimony.

STATEMENT OF ALBERT B. ELLENTUCK, CHAIRMAN, FEDERAL TAXATION EXECUTIVE COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. ELLENTUCK. Thank you, Mr. Chairman, members of the committee.

My name is Albert Ellentuck, and I'm chairman of the Federal Taxation Executive Committee of the American Institute of Certified Public Accountants.

We have submitted a prepared statement, and we have discussed many of the proposals with your staff. As you suggest, I will summarize.

I'll commence and focus on the tax shelter proposals, the accounting issues, and the approach to the corporate tax reforms on tax shelters.

If I might make a general comment, we strongly support the effort to curb abuses in this area. Our concern is that these provisions which are directed at abuses could affect legitimate business partnerships.

There are some strong tools that the Internal Revenue Service has to deal with these abuses, and we believe it would be better to rely on these tools to prevent abuse. If legislation is necessary, however, we believe that it is important to draw the legislation narrow enough so that only abusive situations will be covered.

Specifically as to the partnership item allocations which would allow only bottom line allocations, we believe that it is not necessary to legislate in this area because of proposed regulation 704(b) which is based on "substantial economic effect" and, we believe, would prevent the abuse in this area. We think that since there are proposed regulations, it would be wise to give them a chance to operate in this area.

The same reasoning, we think, applies to retroactive allocations and to contributions of property to partnerships. We believe that arms length negotiations in this area will prevent abuses.

We also believe the aggregate theory of partnership taxation should be applied consistently so that partnership interests should be able to be exchanged tax free where the underlying assets are of like-kind. This could be done at the partnership level, and can also be done at the partner level.

With regard to the time value of money, we support these proposals as they relate to deferred payments. We think the result would be a fair one, and would deal with the abuses in this area.

We would also support the proposal on prepayments for cash basis taxpayers. We think they should be limited to tax shelters, and we think that the exception for goods and services would do well to be at least 12 months, and the de minimis rule should be more than the $10,000 presently proposed.

With regard to the LIFO conformity proposal, I would be remiss if I did not reiterate our longstanding position that LIFO conformity really should be eliminated and should not be part of our tax law.

With regard to the corporate tax reform proposals, as you all know, subchapter C is an extremely complex area of the tax law. We believe that any changes that are considered should not be done piecemeal, but rather as part of an overall revision of subchapter C.

I urge the committee not to act in haste in this area which is so important and so complex.

The Federal Tax Division would be pleased to continue our work with you and with your staff in your study of a comprehensive revision of subchapter C, and we would offer the services of our specialists in this area to help.

I want to thank you, Mr. Chairman, and the members of the committee, for the opportunity to cover these points.

Chairman ROSTENKOWSKI. Thank you, Mr. Ellentuck.

[The prepared statement follows:]

STATEMENT OF ALBERT B. ELLENTUCK, CHAIRMAN, FEDERAL TAXATION EXECUTIVE COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

My name is Albert B. Ellentuck, and I am Chairman of the Federal Taxation Executive Committee of the American Institute of Certified Public Accountants. The American Institute of CPAs has more than 200,000 members, many of whom work daily with the tax laws which you help to write. We are vitally interested in financial and tax accounting issues, and strive to serve the public in these areas.

I am here today to discuss Administration and other proposals concerning tax shelters, "accounting abuses," and corporate tax reform.

TAX SHELTERS

With respect to tax shelters, we fully support efforts to curb abuses. To the extent that others do not pay their fair share of taxes, those who comply with the tax law will have an increased burden. However, we believe careful distinctions should be made in any legislation to curb abusive tax shelters so that legitimate business transactions are not impacted. In this regard, we are concerned that the application of limitations directed at tax shelters to all partnerships, without qualification, will unintentionally and adversely affect many operating, commercial, and business partnerships in their legitimate transactions. There are several sections of the Internal Revenue Code which are already in use to help draw the distinction between legitimate and abusive situations. We believe that emphasis on existing rules should be made before imposing the partnership tax shelter provisions, and perhaps some of the accounting provisions, which have been proposed.

With respect to partnership item allocations, we oppose the change to allow only "bottom line" allocations because we firmly believe that the "substantial economic effect" requirement of the proposed regulations under Section 704(b) provides sufficient protection against abuse. This approach should be given a chance to apply before new basic legislation is attempted.

The proposal with respect to retroactive allocation of partnership deductions is complex and potentially inequitable. We believe that the arm's-length negotiation with respect to the incoming partner, together with the partnership allocation proposed regulations, should prevent abuse.

The proposal on property contributed to a partnership raises significant valuation problems, and, again, we believe the Section 704(b) proposed regulations requirement of "substantial economic effect" will prevent abuses.

We agree with the judicial theory which supports like-kind exchanges of similar partnership interests in different partnerships and believe it should not be overturned in legislation. This theory is based on analysis of the underlying assets and is fair.

The proposed requirement that property to be transferred in a like-kind exchange be identified at the time of the first transfer will adversely affect certain legitimate transactions where such identifications are difficult. If a short period of time is provided in which to complete the transaction, such as the proposed 3 months period, this should give sufficient protection against abuse. We believe that a three-month period is too restrictive and should instead be the due date of the return, including extensions.

We support the proposal with respect to charitable contributions of property, but believe the three-year holding period proposed by the Administration is preferable to the five-year period in Senator Dole's proposals in that it provides sufficient protection without unduly restricting legitimate transactions. The committee may wish to consider limiting this provision to tax shelter situations by establishing a rebuttable presumption, instead of a rule, against an earlier contribution.

"ACCOUNTING ABUSES"

In commenting on "Accounting Abuses," I would first like to say that we believe this term does not fairly describe the problem being addressed. No one, particularly the accounting profession, could oppose "accounting abuses."

With respect to LIFO conformity, the AICPA has had a longstanding position against the LIFO conformity requirement, and we oppose the proposal. In the words of former Assistant Treasury Secretary for Tax Policy Donald Lubick:

"We believe that the time has come to repeal the LIFO conformity requirement. We do not believe that it serves any useful tax policy purpose. Repeal of the LIFO conformity requirement would save taxpayers, taxpayer representatives, and the IRS from the burden of having to deal with rules that do not directly affect the computation of tax liability. In addition, it will greatly simplify the ability of small businesses to use the LIFO methods of inventory valuation."

The proposed legislation is intended to overturn a court decision which supported a taxpayer's use of a device to avoid the LIFO conformity requirement. We believe you should repeal the conformity requirement, rather than trying to close loopholes developed to avoid bad tax policy.

We support in principle the time value of money proposal for deferred payments. However, we are concerned with specific problems in implementation, such as tracing of funds used.

We also agree in principle with the time value of money proposal for prepayments by cash basis taxpayers. However, we believe that the exception for goods or services received should be extended to a period of at least 12 months for the sake of simplification. Simplification would also be served by raising the de minimis amount from $10,000.

On February 24, 1984, I testified before the Oversight Subcommittee on the time value of money for "premature accruals," and I have submitted a copy of that testimony for the record of this hearing.

CORPORATE TAX REFORMS

We believe that changes to Subchapter C should be the topic of separate legislation dealing only with that area. Changes could then be carefully considered, and the entire scheme of corporate taxation could be adjusted as desired. A series of piecemeal adjustments to Subchapter C cannot deal with the complex interactions of various aspects of corporate taxation, and will lead to technical problems, unintended results, and necessary corrective legislation.

The proposals with respect to Sections 311 and 337 will impact small business particularly, and will result in double taxation of earnings in many situations. We believe that these proposals should not be adopted without careful study in connection with a complete package on Subchapter C.

We sincerely appreciate this opportunity to testify on these important matters, and wish to thank your staff for hearing our more technical comments. We stand ready to work with you and your staff on the many complex legislative issues which you are presently considering. I would be pleased to respond to any questions you may have.

Chairman ROSTENKOWSKI. Mr. Padwe, please proceed.

STATEMENT OF GERALD W. PADWE, NATIONAL DIRECTOR, TAX PRACTICE, TOUCHE ROSS & CO., ON BEHALF OF CHAMBER OF COMMERCE OF THE UNITED STATES, ACCOMPANIED BY RACHELLE BERNSTEIN, SENIOR TAX ATTORNEY, U.S. CHAMBER OF COMMERCE

Mr. PADWE. Thank you, Mr. Chairman. Good morning.

My name is Gerald W. Padwe. I'm the national director of Tax Practice for the accounting firm of Touche Ross & Co. I'm here this morning, representing the Chamber of Commerce of the United States, and I'm accompanied here by Rachelle Bernstein, who is senior tax attorney for the U.S. Chamber.

We appreciate the opportunity to present our views and we have presented to you a written statement from which I will summarize.

If you got the same copy of the statement that I did last night, you will find that it is missing about one-third of page 4 and one-third of page 6, but we will provide substitutes for you. We would not want you to miss a word.

In the few minutes that I have, let me concentrate on one or two subjects and refer you to the written statement for the balance of our comments.

The first one deals specifically with the premature accrual proposal of the Treasury Departments which mirrors, to some extent, that of the Senate Finance Committee introduced last fall.

In our view, the proposal is overbroad. It appears aimed at limited types of activity, even if the dollars in some of those activities may be not small: mining reclamation expenses, nuclear utility decommissioning, workmen's compensation, balloon interest payments, and some accrual basis shelter transactions.

We would like to suggest that, to the extent that these are really special issues, that they be dealt with as such, and not as a broad-brush approach to changing a very major premise of the accounting rules in the Internal Revenue Code.

I would point out that Treasury, in its proposals in another area here—the prepayments that Mr. Ellentuck referred to—has recommended the approach be limited to tax shelters. We would suggest, to the extent it is appropriate to limit deductibility of expenses to the economic performance, that should also be done in the context of special types of expenses, rather than completely across the board.

Unfortunately, it is very difficult to tell what may be affected by a broad-brush change in something as basic as general rules of tax accounting. If the provision were, inadvertently, to hit an unintended victim, Congress is far less likely, a few years down the road, to make liberalizing changes at that time for particular groups of taxpayers.

We are also concerned that this is a deduction side proposal only, and that there is no similarity on the income side. It is easy to say the problem does not come up on the income side, and therefore no change in rules is required there. In fact, it does not very often. On the other hand, it does not arise on the deduction side either—very often—though more so in the context of deductions than income. But since this is not an everyday issue, is it necessary, then, to go to the broad-brush approach?

We pointed out in our written testimony that there are at least limited circumstances on the income side where premature accrual may hurt a taxpayer; for example, the Internal Revenue Service has vigorously insisted that taxpayers receiving damage payments or awards from lawsuits, where the amounts may only be receivable over a period of years—say, over a 10-year period—must include the full amount of the damage award in the first year, even though they are not legally entitled to the last part of the award until the 10th year.

So it can happen on the income side as well.

We are concerned that this is a major change in tax accounting, that it essentially is aimed at raising revenue, as opposed to whether or not it is appropriate or fair, and we would like to suggest that it is too broad and, therefore, not fair.

With respect to the taxation of corporations, may I please second the comment that was made by Mr. Ellentuck. In the Treasury proposals, we see a limited reversal of the *General Utilities* case, for example. However, there has also been released a report by the staff of the Senate Finance Committee, proposing a major overhaul of the entire area of corporate taxation, subchapter C, which will be the subject of debate in, undoubtedly, both committees later on, either this year, or certainly next year.

We question the wisdom of what I would call subchapter C reform by salami slice: taking just one aspect of reform at this point and dealing with it. We would urge that this wait until the entire package is on the table at a later time this year, or early next year.

We have commented, however, in our written statement, on specific points with respect to the corporate tax reform issues that have been proposed to you by Treasury. We would call your attention, for example, to the section 367 issue, the factoring of receivables, the tracing problems involved with debt-financed stock acquisitions.

Thank you, Mr. Chairman. We appreciate the opportunity, one more time, to put our views before you.

Mr. GIBBONS [presiding]. Thank you, sir.

[The prepared statement follows:]

STATEMENT OF GERALD W. PADWE, ON BEHALF OF THE CHAMBER OF COMMERCE OF THE UNITED STATES

I am Gerald W. Padwe, National Director—Tax Practice for Touche Ross & Co. and a member of the Taxation Committee of the Chamber of Commerce of the United States. Accompanying me today is Rachelle B. Bernstein, Senior Tax Attorney for the Chamber.

In announcing these hearings on Administration and other proposals concerning tax shelters, accounting abuses, and corporate securities reform, the Chairman has stated, "(t)o the extent that abuses can be curtailed without unduly interfering with ordinary business transactions, Congress should act to reform the law." The Chamber shares the concerns of the Chairman. To the extent that the partnership, accounting, and corporate tax rules are being manipulated to create unintended results, we believe some reform may be in order. However, a number of the proposals being considered call for fundamental changes in tax policy. In some instances, we believe that the change in policy direction is incorrect. In others, we believe that the proposed changes may unintentionally interfere with ordinary, non-abusive business transactions or cause ambiguities in the law which will impede economic activity.

Our testimony before the Committee today reflects some of the problems we have encountered after our initial review of the Administration's proposals in this area. As the details of these proposals, contained in a document which is over 100 pages long, have been available for only one week, we have been unable to review all of the possible ramifications these changes will have on business activity. In many instances the technical explanation of the proposals is unclear, and it will be necessary to review the actual legislative language to assure that these changes do not impede ordinary business transactions. We urge the Committee to allow the public sufficient opportunity to review these proposals in legislative form to assure that unintended effects do not result.

PARTNERSHIP PROPOSALS

Allocations

The Administration has made a number of proposals to restrict so called "retroactive allocations" regarding organization fees, disguised sales and the use of tiered partnership arrangements. Upon initial review, the Chamber finds these proposals unobjectionable. We would point out, however, that the Administration view differs from that of the earlier approach by the Senate Finance Committee which would require partnerships to utilize "bottom line" allocation of income and deductions, and we would recommend that this Committee reject the Finance Committee's proposal of last Fall. Under that proposal, it would be impossible to allocate particular items of deduction or income according to the partnership agreement. Instead, each partner would be allocated a pro rata share of the partnership's net income or loss. Presently, these allocations are already restricted by the requirement that the economic effect of the allocation must be substantial. We believe that present law constitutes an adequate restriction on tax shelter activity. Bottom line allocation would adversely impact the ability to structure transactions to reflect normal and perfectly legitimate business needs.

For example, suppose a company negotiates with a scientific research organization for the purpose of developing a new product. That organization may require a share of the profits generated from the new product. Thus, the company might enter into a joint venture or partnership agreement under which the research organization would receive 20% of the income and the company would receive 80%. The company would supply all of the capital while the scientists provide knowhow. The partnership agreement would probably provide that, if the venture were unsuccessful and the partnership failed to earn any income, the company would be allocated all losses since it would be bearing all the economic risk of the venture. Under a bottom line rule, the research organization would receive both 20% of the income and 20% of any deductions. It is unfair to disallow the agreed allocation of deduction when there is such a substantial economic reason for it. To require the partnership to allocate losses in the same manner as income will often ignore business reality and, in effect, require the partner providing capital (and who is at risk) to risk being forced to pay the other partner the tax value of the deductions should the enterprise fail.

ACCOUNTING PROPOSALS

The Administration has offered several proposals to amend the tax accounting rules of the Internal Revenue Code to reflect the time value of money. They appear to be particularly concerned with tax shelter transactions which provide additional benefits to taxpayers because deductions are taken at an early point in the transaction. The Chamber's concerns in this area are not with preserving unintended tax benefits in the Code but rather with assuring that the accounting rules provide for matching of income and expenses and that income and expense items be treated in a similar manner.

1. Premature accruals

Treasury's proposal with regard to the premature accrual of expenses will result in a great mismatching of income and expenses. Under the current rules for accrual method taxpayers, an expense is deductible for the taxable year in which all events have occurred which determine the fact of the liability and the amount can be determined with reasonable accuracy. Income is accrued when the right to receive such income becomes fixed. The accrual method of accounting is designed to assure that an item of expense is matched with the income it generates.

Under the Administration's proposal, all events which establish liability would not be considered to have occurred until "economic performance" occurs, which generally means when services are performed, property provided, use of property occurs, or the liability is satisfied. This proposal reverses existing policy that a liability is accrued when it is established and would be inequitable because it creates a new rule for the premature accrual of expenses, but not for the premature accrual of income. Under the rules for accrual method taxpayers, if income is required to be accrued prior to receipt, a taxpayer may have to pay taxes on that income at the time of accrual. The Internal Revenue Service has taken that position, for example, where an accrual method taxpayer receives a settlement award in a law suit which is to be received over time. In that situation, we are aware that the Service has required taxes to be paid on the entire amount in the year of settlement even though the settlement agreement provides that payment would be received over a ten-year period. By requiring that income be accrued at the time the right to receive such income becomes fixed but not allowing an expense to be deducted until the liability is satisfied, it appears that Treasury is seeking to maximize revenue without treating taxpayers equally. They are artificially placing taxpayers on either a cash method of accounting or an accrual method depending on which method provides more revenue of the federal government. Such a policy clearly defies our tax rules that require a taxpayer to choose one method of accounting, which clearly reflects income, and to use that method consistently.

This proposal is particularly troublesome to our members who self-insure their workers' compensation risks. Self-insurance, including group self-insurance, is increasingly popular with employers of all sizes. The proposal would eliminate the right to deduct the liability when it accrues, including payments due in subsequent years. Similar considerations can be cited for the tax expensing of supplemental unemployment benefits.

2. Like kind exchanges

Under section 1031 of the Internal Revenue Code, no gain or loss is recognized on the exchange of like kind property. In interpreting this provision, one court, at least, has held that an exchange could qualify for non-recognition treatment where the exchanged property was not designated until five years after the transaction was opened. The Administration has proposed that any property received by the taxpayer more than 90 days after the taxpayer transfers property relinquished in the exchange would be treated as property which is not like kind property. The Chamber believes that 90 days is often too short a period of time during which to complete such a transaction and that the time period should be extended. In the alternative, a liberal statutory definition of "transfer" should be developed so that, for example, a contract signed within 90 days would meet the transfer test, even though it was not possible to arrange passage of legal title within that time.

3. Related party transactions

Under current law, an accrual basis taxpayer is denied a deduction for certain accrued expenses owed to a related cash basis taxpayer unless the expense is paid within two and one-half months after the close of the taxable year in which the expense is accrued. Under the Administration's proposal, related taxpayers subject to this provision would be required to defer the deduction for the accrued amount until the amount is paid. We believe that the two and one-half month leeway period provided under present law should be maintained. Its purpose is a valid one, and does not involve abuse, especially in the context of family or closely-held businesses. The two and one-half months corresponds with the period in which the accrual basis payor must file its tax return; and that allows the requisite time to close the books, determine such items as net income on which bonuses are paid, etc.

4. Tax treatment of premature employer contributions to benefits plans

Under current law, the tax treatment of employee benefits is a carefully conceived policy designed to encourage employers to provide economic protections to their employees. Without these benefits, many might have to resort to government assistance. These tax incentives have been very successful since most employees and their dependents have benefits that provide retirement income, health, life and disability insurance. While some abuse of these incentives has come to light, we are concerned that the vague reforms being suggested are more revenue than policy oriented. We urge the Committee to more carefully consider these suggestions before making any changes. To that end, we would be happy to work with the Committee to examine what changes, if any, might be needed. Similar consideration should be given to the miscellaneous, employee benefit suggestions found in the Joint Committee on Taxation options.

CORPORATE REFORM PROPOSALS

The Senate Finance Committee staff has been engaged in a major study of the corporate tax provisions of the Internal Revenue Code. The Chamber testified on the preliminary report on the staff's proposal for Reform of Corporate Taxation before the Finance Committee last October. Because the provisions of that proposal appear to be outside the scope of today's hearings, we are not commenting on that proposal today. However, the reforms suggested by the Senate Finance Committee staff constitute a major change in our tax policy; accordingly, we recommend no action by this Committee on any such proposals without adequate hearings on the entire subject.

The Administration proposals represent a "first pass" at subchapter C reform, including a limited statutory reversal of the *General Utilities* case. If we knew the proposals represented the last word of Congress and the Administration on the subject, we would be better able to comment on them. However, not only do we not know this, we are quite confident there is more to come; and for that reason we find it hard to guess where the preselt proposals may ultimately fit into the corporate tax structure.

We will, nonetheless, address a few of the problems we see in the corporate reform proposals since comment has been requested, but we ask the Committee to bear in mind our overall disagreement with taking up this subject before the total thrust of Subchapter C revision is "on the table."

1. Debt-financed portfolio stock

Where a corporation borrows funds, interest on the indebtedness is generally deductible against ordinary income. When a corporation receives a dividend on stock, it is generally entitled to an 85 percent dividends received deduction. The Administration is concerned that, where a corporation incurs debt in order to purchase corporate stock yielding dividend income, unintended tax benefits may result. Therefore, the Administration has proposed that, where a corporation incurs debt that would not have been incurred "but for" an investment in stock, deduction of the interest on the debt would be disallowed in an amount equal to the dividends received deduction on the leveraged stock.

The Chamber is concerned with the effect this proposal would have on corporations which incur debt and also invest in stock. It is a common occurrance for a corporation to incur debt to purchase or build a plant, equipment or office building, or to finance receivables or inventories and to also hold stock of another corporation. The Administration's proposal would result in difficulty in tracing for which investment the debt is incurred. For example, it is unclear how this proposal would treat a situation where a corporation borrowed money in 1985, to be repaid by 1995, built a new plant in 1986, and purchased stock of another corporation in 1988. Could it be said that, "but for" the purchase of the stock in 1988, the corporation would have repaid the debt incurred in 1985? Similarly, what would the result be if a corporation borrowed money for its Christmas inventories and purchased stock in January with the income earned on their sale, rather than repaying the debt?

The Joint Committee on Taxation, in its description of proposals for this hearing, has stated that it considers a "more effective" approach would be to disallow interest on debt related to the stock investment under the "but for" rule, even though the debt may not be directly attributable to the stock.

The Chamber is concerned that this proposal, if not very carefully and narrowly drawn, will create substantial disruption in the capital markets by applying to indebtedness incurred for normal business reasons. The Administration's proposal and the Joint Committee's statement indicate that a provision similar to existing section 265 is envisioned. Section 265 limits deductions for interest on debt incurred to purchase tax exempt state and local bonds. However, the proposal, particularly as suggested by the Joint Committee staff, is substantially broader than section 265 and would effectively repeal the dividends received deduction when a corporation has deductions for interest on debt.

Under existing law, corporate income is taxed twice, once at the corporate level and again if distributions are made to shareholders. Without the dividends received deduction, there would be an additional corporate tax. The purpose of the dividends received deduction contained in section 243 is to avoid imposition of an additional corporate tax on distributions received by shareholders of the recipient corporation.

The Administration's proposal, as enhanced by the Joint Committee staff, is much broader than section 265. Under section 265, interest is disallowed only if it is directly allocable to the purchase of the tax-exempt obligation. The Committee's provision should, at a minimum, be limited to interest on borrowings which have been incurred directly to purchase stock, and legislative language should be carefully drafted to achieve that result. The proposal should be addressed only to specific defined abuses. If Treasury and this Committee are concerned about particular abusive situations, those should be targeted. For example: (1) cases where non-recourse debt is incurred by a trust solely to purchase preferred stock which is used as security for the debt and where dividends are distributed to the beneficiaries; or (2) cases where indebtedness is incurred to purchase preferred stock on margin.

On February 22, Treasury stated that it would supply examples of specific abuses to this Committee. We urge the Committee to limit any action in this area to assure that only abuses are addressed and that normal business transactions are not affected.

2. Certain transfers of appreciated property to foreign corporations

Under current law, assets may be transferred tax-free to a foreign corporation if the Internal Revenue Service rules that the transfer does not have as its principal purpose the avoidance of Federal income tax. Under I.R.S. guidelines a favorable ruling is generally granted if the assets are transferred for use in the active conduct of a trade or business abroad. The guidelines also list certain "tainted" assets, that have either an element of "built-in" income or that are readily disposable by the transferee which will be subject to tax on their transfer. The Administration has proposed codifying the I.R.S. guidelines and substituting an "effects" test for the principal purpose test currently used. Thus, nonrecognition would be denied if the transfer was of a "tainted asset" or of an asset which is not used in an active trade or business and would, therefore, have the effect of avoidance of Federal income tax. In addition to these rules, the Administration has proposed that where an intangible is transferred to a foreign corporation, the transferor would be required to include in income annually an amount that would equal a reasonable royalty for the use of the intangible transferred and that the amount of the royalty woud be considered U.S. source income.

The proposal regarding intangibles causes several problems for our members. First, it discriminates between the transfer of intangibles and the transfer of other property that could receive tax-free treatment ulder section 367. Second, characterization of the deemed royalty as U.S. source income would result in substantial double taxation. Third, substantial litigation will be generated over the determination of whether a transfer of property has in fact occurred because it is particularly difficult to make such a determination in the technology area. Fourth, problems will arise in determining the value of the assets transferred, which is particularly difficult in the case of intangibles.

This proposal contains a policy prejudice in favor of companies' licensing, rather than transferring, intangibles. The problem with this approach is that many developing countries either require that a company must own, rather than license, intangibles or require prior government approval before a licensing agreement may be entered. Furthermore, in many instances the amount of royalties these countries may permit to be paid may be so low that the payment required by the Administration proposal may have to be treated as a dividend under foreign law, and dividends in many of these countries are subject to extremely high tax rates. The fact that these "royalty" payments will be considered as U.S. source income will increase the double taxation which would otherwise result. The problems which U.S. business has in complying with the strict requirements of these less developed countries is exacerbated by the fact that we do not have tax treaties with most of them.

The Chamber is concerned about the impact that these restrictions on the transferability of intangibles will have on our international competitiveness. The imposition of this provision may cause U.S. companies to perform their research and development activities overseas, rather than in the United States.

Furthermore, an exception to these rules should be made for companies that have worldwide cost sharing agreements so that the transfer of intangibles by these companies would be treated as if they were licensing. Any problem the Administration may have with the fact that the expenses of developing intangibles might be incurred in the United States would not exist in these cases because the foreign subsidiaries would be sharing in the cost of such development. There may be a need to provide an exception to the rules requiring royalty payments where foreign law prohibits the making of such payments. Finally, the deemed royalty payment should be considered foreign source income since the property is used outside the United States.

The Administration's proposal also calls for the codification of the present IRS policy not to issue a favorable ruling on the incorporation of a foreign branch by a U.S. transferor unless the transferor agrees to recapture the branch's prior accumulated losses. We question whether it is appropriate, in view of the Code's overall limitation on the foreign tax credit, to require the recapture of foreign losses that have offset foreign, rather than U.S., source income. Moreover, there are a number of important technical problems that greatly complicate such a proposal. Among these problems are that any recapture should take into account the magnitude of the actual tax benefits, if any, derived from the loss. Further, problems arise as to the timing of when a loss should be recaptured and as to double taxation of income by the United States if the loss is recaptured prematurely.

Under the guidelines, a taxpayer can demonstrate to the IRS that a transfer of a "tainted asset" did not, in fact, have as a principal purpose the avoidance of Federal income tax. There should be an opportunity under the "effects" test for a taxpayer to demonstrate extenuating circumstances demonstrating a lack of tax avoidance purpose. Moreover, we recommend the retention of certain procedural rules which give a taxpayer the right to request a ruling and obtain a declaratory judgment if the IRS fails to issue a ruling in a reasonable period of time or issues a negative ruling. These transactions are too important and too expensive for taxpayers not to have assurances as to how particular transaction will be characterized.

We believe that this proposal should not be enacted without further study of the business practices of those companies involved in transfers of technology as well as all other transfers because the vast majority of these transfers occur in the ordinary course of business and are not performed for tax avoidance purposes. We welcome the opportunity to work with the Committee and the Administration to develop rules which eliminate abusive situations without interfering with ordinary business transactions.

INCOME FROM FACTORING TRADE RECEIVABLES

Many domestic and multinational corporations factor accounts receivable as a means of obtaining financing for continuing operations. Generally, this is done by selling the receivables, at their face value less a discount, to a third party (factor). The factor will attempt to collect on the receivables and will have income on the excess collected over the purchase price of the receivables and costs incurred in collecting on the receivables. Often times the factor may be a related corporation which has more cash than the party selling the receivables.

The Administration's proposal would treat the factoring income earned by a controlled foreign corporation from factoring for related parties as "tax haven" type income under Subpart F of the Internal Revenue Code, which means that the U.S. shareholders would be currently taxable on that income even if the income is not distributed to the shareholders. This provision was included in the Foreign Sales Corporation Act of 1983 (H.R. 3180) and, in that bill, carried an effective date of August 4, 1983.

We believe that the factoring of receivables supplies an important source of financing for businesses and that its tax treatment should not be changed. Where factoring is used to obtain financing for a U.S. parent from a foreign subsidiary, which is the situation addressed in this proposal, that capital may be used for further exporting. At a time when our policy objectives have been directed toward promoting U.S. exports and making U,S. exporters more competitive in a world market, Congress should not enact legislation which may cut off an important source of export financing. If the Administration and this Committee believes that abuses exist in this area, we would be pleased to work with you to craft legislation which addresses only those abusive situations.

Additionally, we consider it to be bad tax policy to enact tax provisions retroactively. It is extremely unfair to the vast majority of taxpayers who become aware of changes in the law only after enactment. It also makes it impossible for businesses to plan transactions in advance.

CONCLUSION

The Chamber supports the efforts of the Administration and this Committee to reform abuses of our tax system. However, we are extremely concerned about the effect that many of these proposals may have on ordinary business transactions and the effect on business activity that may result from uncertainties in our tax system. Our comments before the Committee today do not attempt to address all the problems which may result from the provisions proposed. We look forward to working with the Committee on these proposals once legislative language has been drafted.

Mr. GIBBONS. Our next witness is Mr. Piliero.

STATEMENT OF DANIEL J. PILIERO II, PRESIDENT, AD HOC COMMITTEE FOR A RESPONSIBLE TAX POLICY, AND BENJAMIN O. FEIN, MEMBER, AD HOC COMMITTEE FOR A RESPONSIBLE TAX POLICY, AND SENIOR VICE PRESIDENT, INTEGRATED RESOURCES, INC.

Mr. PILIERO. Thank you, Mr. Chairman.

Mr. Chairman and members of the House Ways and Means Committee, my name is Daniel J. Piliero. I'm president of the Ad Hoc Committee for a Responsible Tax Policy, and a member of the firm of Tighe, Curhan & Piliero.

Accompanying me is Benjamin O. Fein, a member of the Ad Hoc Committee for a Responsible Tax Policy and senior vice president of Integrated Resources, Inc. Mr. Fein is a former tax partner at the law firm of Rosenman, Colin, Freund, Lewis & Cohen.

We appreciate the opportunity to appear before the committee to comment on the administration's proposals on the time value of money. We are here to discuss that portion of the time value of money proposal which deals with deferred payments. Mr. Fein will address this topic in more detail.

Our committee was organized in 1982 with the primary goal of presenting to the Congress the views of taxpayers who have concerns about proposed changes in the tax laws. The initial impetus and financing for the committee comes from taxpayers who are members of the investment and business communities throughout the country.

The primary goal of the committee is to focus attention on the concerns of taxpayers in the investment community. The committee focuses on bills and proposals pending before Congress which have the potential to impact adversely on investment and capital formation and, thereby, on all sectors of our economy.

As an example, the committee should be aware of the fact that throughout much of the seventies when capital was unavailable, many of the transactions which may be inadvertently called today "tax shelters" were, in fact, not shelters but methods by which economic recovery began in the form of real estate financing and other kinds of exploration and development.

Mr. Fein will talk about time value of money, and we would urge the committee to keep an open mind before it categorizes the subject of what is or is not an abusive tax shelter.

Thank you.

Mr. Fein will continue at this point, Mr. Chairman.

Mr. **GIBBONS**. Mr. Fein, go right ahead.

Mr. **FEIN**. We commend this committee and the administration's continuing effort to ferret out of the Internal Revenue Code those loopholes giving rise to unintended tax benefits and the addition of provisions fostering equity, tax neutrality, and simplicity.

We applaud the Treasury for last week's testimony of Assistant Secretary Chapoton before this committee, in clearly distinguishing between abusive tax shelters, on the one hand, and those investments which are enhanced by certain tax incentives, and which further, rather than frustrate, national social, policy.

We should not paint all tax shelters with a single brush. Municipal bonds, contributions to IRA and Keogh plans, investments in partnerships which further and foster capital formation in the form of equipment, plant, housing for the poor and elderly, oil and gas exploration and development, have helped fuel the beginning of our economic recovery and support broad national, social, and economic goals.

Therefore, to the extent that the proposals today adversely effect abusive tax shelters, which we believe they generally do, we support such legislation and the continued enforcement of antiabusive provisions presently on the books, so as to eliminate the cancer of abuse from an otherwise healthy social vehicle.

While we generally support the administration's proposals, we do believe that there are two modifications that must be made to the recommended legislation regarding the deferred payments, so as not to fuel inflation and create inherent inequities, and, in the words of Assistant Secretary Chapoton last week, "unquestionably add to the complexity of the tax laws."

The two proposed modifications, simply, are that the expanded OID rules, as it applies to a cash basis creditor, should not, by legislative fiat, create theoretical income not received, but taxed, to a cash basis creditor. The minimum safe harbor rate, which would be a compound rate, of section 483 as revised, should be somewhat less, rather than more, than those charged on comparable Treasury securities.

To suggest the imposition of a minimum rate, based on today's interest rates of securities of over 14½ percent, would be inflationary at best, and would be an unfortunate statement by the Congress as to what it deems an appropriate interest rate in deferred payment transactions to be.

None of our recommended changes would adversely affect, to any degree, the fulfillment of the purposes of the administration's proposals to combat the overstatement of deductions by accrual basis taxpayers, the premature accrual of interest deductions not economically incurred, or the overstatement of property cost, resulting in excessive depreciation deductions or investment tax credits. Those would be left unaffected by the rest of the administration's proposals.

In the interest of brevity, I would just ask that you look at the balance of the prepared statements to see some of the examples of what I believe to be the unintended economic effects that would result unless these two modifications were made.

I thank you for this opportunity.

[The prepared statement follows:]

Statement of Daniel J. Piliero II and Benjamin D. Fein for the Ad Hoc Committee for a Responsible Tax Policy

Mr. Chairman and members of the House Ways and Means Committee, my name is Daniel J. Piliero II and I am President of the Ad Hoc Committee for a Responsible Tax Policy and am a partner in the law firm of Tighe, Curhan & Piliero. Accompanying me is Benjamin D. Fein, a member of the Ad Hoc Committee for a Responsible Tax Policy and a Senior Vice President of Integrated Resources, Inc. Mr. Fein is a former tax partner at the law firm of Rosenman, Colin, Freund, Lewis & Cohen.

COMMENTS OF DANIEL J. PILIERO II, ESQ.

We appreciate this opportunity to appear before the Committee to comment on the Administration's proposals on the time value of money. We are here to discuss that portion of the time value of money proposal which deals with deferred payments. Mr. Fein will address this topic in more detail.

The Ad Hoc Committee for a Responsible Tax Policy was organized in 1982 with the primary goal of presenting to Congress the views of taxpayers who have concerns about proposed changes in the tax laws. The initial impetus and financing for the Committee comes from taxpayers who are members of the investment and business communities throughout the country. The primary goal of the Committee is to focus attention on the concerns of taxpayers in the investment community. The Committee focuses on bills and proposals pending before Congress which have the potential to impact adversely on investment and capital formation and thereby on all sectors of our economy.

The Ad Hoc Committee for a Responsible Tax Policy supports most of the proposals of the Administration relating to so-called "accounting abuses" and a portion of the proposal which addresses the time value of money. However, the Ad Hoc Committee for a Responsible Tax Policy is concerned with inherent inequities, lack of tax neutrality, potential economic hardships and problems in administration which may occur if the time value of money-deferred payments proposal is enacted without modification.

Specifically, we believe that the economic accrual rules should be used only to determine, for the accrual basis debtor, the amount of interest deduction which is appropriately allocable to the taxable period and the time of its deduction. We also believe that the minimum, or safe harbor, rate of Section 483 should not exceed nine percelt compounded. Moreover, any compound rate which amounts to more than 80 percent of the rate charged on Treasury securities of comparable terms would be inflationary and therefore highly objectionable.

Thank you for this opportunity to testify before the Committee. Mr. Benjamin Fein will provide additional testimony.

COMMENTS OF BENJAMIN D. FEIN, ESQ.

Mr. Chairman and Members of the Committee: I appreciate the opportunity to testify before you today regarding certain Administration proposals in the area of tax shelters and so-called "accounting abuses." We commend the continuing effort to ferret out of the Internal Revenue Code those "loopholes" giving rise to unintended tax benefits and the addition of provisions fostering equity, tax neutrality and simplicity. We also applaud the Treasury, through last week's testimony of Assistant Secretary Chapoton before this Committee, in clearly distinguishing between abusive tax shelter transactions, on the one hand, and those investments which are enhanced by certain tax benefits and which further, rather than frustrate, national social policy.

We should not paint all "tax shelters" with a single brush. Municipal bonds, contributions to IRA and Keogh plans, investments in partnerships which further and foster capital formation in the form of equipment, plant, housing for the poor and the elderly, and oil and gas exploration and development have helped fuel the beginning of our economic recovery and support broad national, social and economic goals. Therefore, the extent that the Administration's proposals adversely effect abusive tax shelters, which we believe they generally do, we support such legislation and the continued enforcement of anti-abusive provisions presently on the books, so as to eliminate the cancer of abuse from an otherwise healthy social vehicle.

I. PROPOSED MODIFICATIONS

While we generally support the Administration's proposals, we do believe that two modifications need be made to the recommended legislation regarding "Time Value of Money-Deferred Payments" so as not to fuel inflation, create inherent inequities, lack of tax neutrality and, in the words of Assistant Secretary Chapoton "unquestionably add to the complexity of the tax laws."

The two proposed modifications are that:

(1) The expanded "OID" rules should not be applied so as to create, by legislative fiat, "theoretical income," income not received, but taxed, to a cash basis creditor; and

(2) The minimum "safe harbor" interest rate, of section 483, should be somewhat less (say 80%) rather than 120% of the rates charged on Treasury securities of comparable terms.

Neither of our recommended modifications would adversely affect, to any significant degree, the fulfillment of the purposes for the Administration's proposals to combat (i) the overstatement of deductions by accrual basis taxpayers, (ii) the "premature" accrual of interest deductions not economically incurred, or (iii) the overstatement of property cost, resulting in excessive depreciation deductions and investment tax credits.

SUMMARY

In the interest of brevity, I will only highlight some of the problems presented by the sweeping extension of section 1232 as proposed. A more specific analysis of these issues is presented in the written text of this testimony previously submitted.

The extension of section 1232 could lead to the taxation of Real Estate Investment Trusts (which would otherwise be tax exempt). This would adversely effect such entities.

This extension would reduce or eliminate the availability of certain purchase money financing in many real estate transactions. This would impose an increased demand on commercial lending institutions and result in higher interest rates.

It would reduce, if not eliminate, the willingness of cash basis suppliers of goods and services to agree to a deferral of payments from financially troubled debtors—increasing the number of bankruptcies.

In some situations, the proposed extension would result in effective tax rates of 100% or more being imposed on cash basis creditors.

The proposed application of the 1232 rules to all cash basis sellers of property and providers of services involved in ordinary business transactions would greatly add to the complexity of the application of the tax laws. This point was readily admitted by Secretary Chapoton last week when he concluded that such a result was "unquestionable."

Finally, rejection of a "mandatory" section 483 compound interest rate of 14% (120% of today's medium term Treasury bonds) which counter the reappearance of an inflationary high-interest spiral and serve as a positive policy statement by this

Committee to the Nation relating to congressional policy regarding "appropriate" interest rates.

II. CRITICISMS OF GENERAL EXTENSION OF SECTION 1232 ("OID")

To the extent that the extension of section 1232 has as its purpose requiring accrual basis debtors to apply an "economic accrual" concept to determine their deductions, the proposal comports with economic reality and responds to a perceived abuse.

To the extent that this proposal would require a cash basis creditor to be taxed on the "theoretical income" of interest not actually or constructively received by the taxpayer, significant conflicts with the cash basis method of accounting and with normal business practices would occur. In fact, cash basis real estate investment trusts (REITS) making OID loans, could find themselves bankrupt due to the requirement that they distribute substantially all of their income to their shareholders. However, due to the proposed inclusion of "theoretical" interest income, which REITS (as is the case for any cash basis taxpayer) are obviously incapable of distributing (because it does not exist), the REITS could become fully taxable as a corporation without any cash with which to pay the tax. Other cash basis taxpayers would be similarly affected.

The general application of section 1232A to all indebtedness issued for property or services appears to be an inappropriate method of accomplishing this goal. The consequences of extending OID treatment to all cash basis sellers of property or providers of services, such as proprietorships, partnerships, Subchapter S corporations, and other small- or medium sized businesses would be chaotic. The OID rules have always been restrictive in scope to types of transactions such as bond issuance and purchases which only the more sophisticated taxpayers would undertake. Thus, only taxpayers who are fully aware of the impact of the OID provisions have, as of this time, been concerned with their consequences. Moreover, most OID obligations today are purchased by pension funds and other tax-exempt entities.

If the OID rules were expanded to include transactions which are engaged in daily by ordinary taxpayers, it is reasonable to assume that many such taxpayers would inadvertently ignore the complex OID reporting provisions or that taxpayers attempting to comply with the provisions would have to make difficult judgments to determine the amounts of OID resulting from their transactions. If the OID rules are extended to include common business transactions, the result will be that most, if not all, taxpayers will require professional assistance in order to comply with the OID reporting provisions. This problem would affect both cash basis and accrual basis taxpayers on the "income" or creditor side of these transactions. In addition, during each deferral year, additional complex calculations would be necessary to compute "theoretical income" which a cash basis seller would be required to report annually.

III. EXAMPLES OF HARDSHIP SITUATIONS WHICH WOULD OCCUR SHOULD THE PROPOSED EXTENSION OF SECTION 1232A AND RELATED DEFERRED PAYMENT PROPOSALS BE ENACTED WITHOUT MODIFICATION

a. *Purchase money financing by cash basis sellers would virtually be eliminated.*—Most cash basis sellers would no longer be willing to finance, in part, the sale of their vacation or second homes, businesses, etc. (to the extent that principle and interest would exceed $250,000), by extending purchase money financing which defers payment of a portion of current interest payments, if those sellers were required to recognize income for tax purposes that they would not receive nor be entitled to receive in a given year. The extension of the OID rules with respect to cash basis sellers of property or providers of services would, in large numbers of ordinary transactions, effectively repeal the cash basis method of accounting. An unconscionable result would occur if an ordinary taxpayer unwittingly entered into transactions which would require "theoretical income" to be reported by the taxpayer in years in which no payments for the taxpayer's property or services were received.

For example, a seller (in a 60 percent effective state and federal tax bracket) granting purchase money debt (of say $200,000) at 10 percent compounded per year, wherein the seller is only required to pay 6 percent and accrue on a compound basis the balance which would be payable in a single payment in five years, would effectively pay tax at a rate exceeding 100 percent of the cash received. In year one, he would be taxed on $20,000, have a tax liability of $12,000 and received only $12,000. In year two, his taxable income would be $20,800 and his tax liability ($12,480) would exceed 100 percent of the cash he is entitled to receive ($12,000) in such year.

b. *Extension of the OID Rules in Order to Prevent the Accrual Basis Debtor From Claiming Inappropriate Deductions Is Unecessary Because No Distortion Exists With Respect to the Cash Basis Creditor's Side of the Transaction.*—If a cash basis recipient of such deferred payments were required to recognize as taxable income the accrued amounts which the seller would be required to deduct under the principles of section 1232A, such inclusions would necessarily overstate and distort his income under the cash basis method of accounting. Both the accrual basis and the cash basis methods of accounting provide effective and efficient alternatives for taxpayers to monitor their finances and compute their income. It is not proposed by the Administration that cash basis taxpayers be permitted to deduct accrued and unpaid deductible expenses. To require such taxpayers to recognize such theoretical income without permitting similar deductions creates "mismatching" and inequity, it does not diminish it. It is important that both accounting methods be preserved.

c. *Extension of the OID rules to require a seller of property or provider of services to recognize "theoretical income" for tax purposes would greatly limit the willingness of creditors and suppliers of cyclical industries and economically troubled businesses to negotiate the deferral of payments in lieu of current payments.*—If cash basis creditors and suppliers were required to recognize "theoretical income" as a result of their willingness to assist marginal businesses by accepting such deferred payments in lieu of present payments, these creditors and suppliers would probably find it uneconomical to do so. Thus, it would be more difficult for marginal businesses to survive cyclical periods, and the number of bankruptcies could be expected to rise.

d. *The utilization of seller-provided purchase money debt is not an abusive technique but one used for decades in financing the sale of real property. Real estate does not qualify for investment tax credits and therefore does not give rise to one of the abuses perceived.*—If the OID proposals are enacted in the present forms, we suggest that they except purchase money financing relating to the sale of real estate (where the compound debt-rate of such financing meets the safe harbor test of section 483 discussed below).

IV. CRITICISMS OF SECTION 483 MODIFICATIONS

We favor the proposed adoption of an economically realistic compound, rather than simple interest rate, and one which fluctuates to more closely reflect market conditions. However, the section 483 safe harbor rate is designed to reflect the lowest effective interest rate which taxpayers may negotiate between themselves in deferred payment transactions, without the tax law recharacterizing the terms of their business transaction for tax purposes. Such recharacterization should occur only where the parties to a commercial transaction establish an unreasonably low rate of interest and thereby distort both the basis of property transferred and the character of the payments made.

The adoption of a relatively lower section 483 safe harbor rate of interest than that apparently proposed by the Administration on February 17, 1984, reflects that sellers of property do not expect to receive interest rates comparable to those charged by commercial institutions. In addition, mandatory safe harbor rates which set rates equal to, or in excess of, the rate of Treasury securities would merely continue to fuel an inflationary high-interest spiral. It would also serve as a negative policy statement to the nation at large as to federal policy regarding "appropriate" interest rates.

If section 483 is modified as suggested, it could readily serve as a "backstop" guarding against unreasonably low designations of interest-equivalents where property is sold or services are provided for deferred payments. Where the compound rate of interest stated by the parties to such a transaction, equals or exceeds the section 483 safe harbor rate, the terms of the parties' agreement should be respected. Where, however, the rate stated is less than the section 483 safe harbor rate, the section 483 imputation rate should be used to determine amounts which should be treated as interest-equivalents for Federal tax purposes, to be deducted by the payor and included by the recipient as described above.

CONCLUSION

A. Current accounting principles should continue to govern the inclusion in income of the "Interest" Component inherent in such deferred payments so as not to cause cash taxpayers to recognize "theoretical income" for tax purposes.

B. Section 483 should be amended to require the compound method or economic accrual of interest, however the "Safe Harbor" compound rate should not be inflationary in effect and hence should be two percentage points below (or 80 percent of) that carried on corresponding Treasury securities. A higher rate (as that suggested by the Administration) could be "imposed" or imputed only if the foregoing "minimum rate" is not stated as is presently the case under Section 483.

Thank you for this opportunity to present our observations and suggestions regarding this legislation. We would be pleased to answer any questions that you may have.

Mr. GIBBONS. Thank you, sir.

Our next witness is Mr. Berenson.

STATEMENT OF DAVID A. BERENSON, PARTNER IN CHARGE OF WASHINGTON TAX SERVICES, ERNST & WHINNEY

Mr. BERENSON. Thank you.

Mr. Chairman, members of the committee, I am David Berenson, partner in charge of Washington Tax Services of Ernst & Whinney. Due to our time constraints, I will address only certain key proposals, although my detailed submission on all proposals is available for your consideration.

I appreciate the opportunity of appearing at this hearing.

First, I thought it would be appropriate to comment on the proposals regarding partnerships and other passthrough entities. We are concerned about the impact in the business community resulting from the additional complexity that some of these overly broad provisions would supply. We fully support those proposals that are more targeted and necessary to remove specific unintended benefits in the abusive tax shelter area.

However, many of the proposals will undoubtedly encompass and complicate nonshelter or nonabusive partnership operations and affect transactions where no perceived inequity exists.

Congressionally mandated areas involving previously enacted tax incentives, such as low-income housing, would be broadly affected by these provisions. In certain areas, refinements of these proposals to eliminate their sweeping impact are possible. However, in many circumstances, this does not appear to be feasible.

The administration's proposal could lead to a proliferating complexity of tax accounting for partnerships, as compared to basic cash or accrual business accounting, primarily in the area of special allocations which would be mandated on all contributions of property to partnerships. The price of eliminating a perceived equity for a small number of partnerships in this area of the tax system, we feel, would be too high in terms of increased complexity for all partnerships.

Furthermore, the extension of the at-risk rules to real estate may have appeal from a tax policy standpoint, but we feel the economic impact should deserve further study at this point. Further to limit its application possibly just to limited partnerships, we feel, would discriminate against the small investor, as contrasted to those investors of vested wealth, who really do not need the limited partnership vehicle.

In the area of taxation of corporations and their shareholders, the limitation on the dividend received deduction with respect to debt-financed portfolio stock, properly removes an unintended benefit. However, this provision should only apply to stock that was not held for at least 1 year. When stock has been subject to substantial market risk by being held for more than a year, the questionable investment motive should be cured and the method of financing thereafter should become irrelevant, as with any other favorably taxed asset.

Furthermore, we feel that we should be looking to a modified form of corporate/shareholder tax integration. and in conjunction therewith the dividends-received deduction should be increased to 100 percent to properly mitigate multilevel corporate taxation.

With respect to the proposal regarding extraordinary dividends received by corporations, clarification is necessary as to when the holding period is measured. It is not clear at present whether it includes the postdistribution period or only the predistribution holding period, and whether it is intended to grant former partial liquidation treatment to property received in such distributions. For example, if you have a stock purchase at $100, with a $20 extraordinary dividend, and that $20 is represented by depreciable property, you could wind up back with the type of partial liquidation treatment that was eliminated by legislation effective August 1982. I do not think such a result would be intended. However, there should not be a permanent loss of the $20 basis.

Furthermore, with respect to the earnings and profits proposal, we believe the concept of earnings and profits to be unduly complex, and being hampered by knowledge of its practical application by the general business community, we have found it to be administratively out of hand in many cases. Nevertheless, it should not be repealed, unless it is coupled with a broader study of the corporate tax structure and a modified form of integration.

In the absence of a modified form of integration that should enable repeal, we feel that E&P should be more specifically defined in accordance with present general concepts of income realization and recognition, rather than by adopting a new amorphous concept of economic income which comports to neither tax accounting nor generally accepted accounting principles and which will just introduce more uncertainty into the code.

With respect to time value of money and accounting issues, the administration's proposal on prepayment of expenses introduces a new, hybrid method of accounting, entailing additional recordkeeping which will have wide applications beyond the situations of abuse for which it is apparently intended.

Unintended benefit areas should be targeted for reform, rather than broad adoption of a complex hybrid accounting method that departs further from the basic cash or accrual language of business.

Proper tax policy would also require symmetry of treatment on the revenue side with respect to prepaid income if such proposals are carried forward. Also, policy dictates that the same tax transaction should not be treated differently between different taxpayers, and that is what we will be legislatively embarking upon in the partnership area.

Any proposal should be narrowed to exclude prepayments allocable to the immediately following year, and should be carefully structured so as to not unduly hamper the research and development partnerships which are vital to economic competitiveness of the country at this point.

In the interest-free loan area, notwithstanding the recent Supreme Court case with respect to gift taxes the administration's proposal does reverse longstanding precedent-setting cases in the income tax area, upon which taxpayers have relied although disputed by the IRS. We recommend accordingly that the existing interest-free loans that are already outstanding be grandfathered pursuant to current case law, or permitting a 5-year period until 1988 to unwind existing loan positions presently interwoven in taxpayers financial affairs.

This would enable an orderly restructuring of such loans because, otherwise, we find that, with respect to these existing loans, the proposal would favor the vested wealth interest as compared to the executive-employee who would be deemed to have received compensation and who do not have the other passive income to offset the effects limitations on interest such as under the alternative minimum tax.

Our final comment is in the area of premature accruals. This proposal also introduces an overly broad and complex hybrid method of accounting which would affect countless taxpayers conducting transactions in the ordinary course of business. This method would not provide for a clear reflection or accurate measurement of income, because current taxable income would be overstated by not properly matching expenses with related income. Unintended benefits, again, should be targeted specifically, rather than by wholesale changes of establish tax accounting concepts.

We recommend that the administration proposal not be adopted. However, if it is, an automatic "safe harbor" provisions should apply to accrual situations where performance occurs within a 5-year period. Also where the paying and receiving taxpayers are either in symmetry in their accounting methods or elect to be in symmetry, there should be no limitation on accruability.

With respect to long-term obligations in excess of 5 years, not capable of symmetry between paying and receiving taxpayers, such as in the regulatory area, amortization of the obligation over the period benefited would be more appropriate.

Our written submission to the committee presents more detail on our comments and specifically addresses the important area of involving foreign corporations and is available for the committee's and staff's analysis and request for information.

We thank you for the opportunity to testify.

Mr. GIBBONS. Thank you.

[The prepared statement follows:]

STATEMENT OF DAVID A. BERENSON, ERNST & WHINNEY

SUMMARY OF TESTIMONY

I am David A. Berenson, Partner in Charge of Washington Tax Services for the international accounting firm of Ernst & Whinney. Thank you for the opportunity to appear at this hearing. I have several comments on the items under discussion.

Partnerships and other passthrough entities

(1) Additional complexity.—We support those proposals necessary to remove specific unintended benefits in the "tax shelter" context. However, many of the proposals will unduly complicate "nonshelter" or "nonabusive" partnership operations and affect transactions in which no perceived inequity exists. In certain instances, refinement of the proposals may be possible to ameliorate our concerns; however, in

other circumstances, this does not appear possible. The Administration's proposal would lead to proliferating partnership accounting complexity such as, for example, special allocations on all contributed property.

(2) Disguised sales.—The proposal concerning disguised sales would improperly encompass distributions of mortgage proceeds. The legislation should therefore exclude such transactions.

(3) Extension of at-risk rules to real estate.—The proposal to apply the at-risk rules to real estate may have some appeal from a tax policy standpoint, but we feel the economic impact of the proposal deserves further study.

Taxation of corporations and their shareholders

(4) Debt-financed portfolio stock.—The debt-financed portfolio stock proposal properly removes an unintended benefit. However, it should only apply to stock that was not held for at least one year. The dividends-received deduction should be increased to 100 percent to properly mitigate multilevel corporate taxation.

(5) Extraordinary dividend received by corporations.—The extraordinary dividend proposal needs to be clarified as to when the holding period is measured and whether treatment similar to partial liquidation treatment is intended.

(6) Ordinary dividend of appreciated property.—A distributing corporation should not be taxed on a dividend of appreciated property unless a modified from of integration of the two-tier system of corporate-shareholder taxation is adopted.

(7) Short sale transactions.—While we are in agreement with the proposal to capitalize certain payments on short sales, we believe that little benefit would be derived from characterizing deductible payments in lieu of dividends as "interest" for purposes of Sections 163(d) and 265. Comparison should be made of the current treatment of such payments under the alternative minimum tax and Section 163(d).

(8) Earnings and profits.—While the concept of earnings and profits is unduly complex, it should not be repealed unless a modified form of corporate-shareholder integration is adopted. In the absence of such integration, we suggest that E&P be more specifically defined in accordance with general concepts of income realization and recognition rather than an amorphous concept of "economic income."

Time value of money and other accounting issues

(9) Prepayment of expenses.—The Administration's proposal introduces a new hybrid method of accounting entailing additional recordkeeping, which will have wide application beyond the situations of "abuse" for which it is apparently intended. Unintended benefit areas should be targeted for reform rather than the broad adoption of complex hybrid accounting methods that depart further from the basic cash or accrual concepts of business. Proper tax policy would also require symmetry of treatment on the revenue side with respect to prepaid income. Any proposal should be narrowed to exclude prepayments allocable to the immediately following tax year.

(10) Interest-free loans.—Notwithstanding the recent Supreme Court decision in the gift tax area, the Administration's proposal reverses long-standing, precedent-setting cases in the income tax area upon which taxpayers relied. We recommend that existing interest-free loans be grandfathered under present law or the effective date of any such changes be made prospective to 1988 to permit an orderly restructuring of such loans. We also recommend that the $10,000 exemption for interest-free loans in the service-related area be significantly increased and that certain advances be exempt if no compensation is intended.

(11) LIFO conformity.—In light of the current trend toward relaxation of the LIFO conformity rules, we question whether the Administration's proposal is warranted. We believe the IRS already has sufficient power to attack any truly abusive situation in this area.

(12) Premature accruals.—The Administration's proposal introduces a new, overly complex hybrid method of accounting, which would affect countless taxpayers conducting transactions in their ordinary course of business. This hybrid method would not provide for an accurate measurement of income becuase current taxable income would be overstated by not matching liabilities (expenses) with related income. Unintended benefits should be targeted for reform rather than a complete repudiation of the time-tested "all events" test. We recommend, therefore, that the Administration's proposal not be adopted; but if it is, an automatic safe-harbor provision should apply to accrual situations within a five-year period. When the paying and receiving taxpayers are either in symmetry in their accounting methods or elect to be, there should be no limitation on accruability. With respect to long-term obligations in excess of five years, not subject to symmetry between paying and receiving taxpayers, such as in the regulatory area, amortization of the obligation over the period benefited would be appropriate.

(13) Premature employer contributions—VEBA's.—We believe that the proposals are much more complex than necessary to provide a remedy for the problems in this area. The concern over the use of a VEBA primarily as a tax shelter for owner-employees can be addressed by providing a cap on the percentage of benefits allocated to "key employees." Further, the concern regarding the use of VEBAs as a funding vehicle for so-called welfare benefits that are actually deferred compensation can be remedied by providing a clear distinction between what constitutes a welfare plan versus that of a deferred compensation plan.

PARTNERSHIPS AND OTHER PASSTHROUGH ENTITIES

Our self assessment tax system depends largely on a public perception that the system is equitable and that compliance is not burdensome. After examining various partnership provisions and other provisions, the Administration has proposed changes it believes are necessary to remove certain unintended "tax shelter" benefits. Viewed in the narrow "tax shelter" context, the proposals appear to create a more equitable system.

Viewed in the context of ordinary business transactions, however, many of the Administration proposals unduly complicate legitimate partnership operations or affect transactions where no perceived inequity exists. In some cases, the Administration's proposals can be modified to avoid affecting such transactions. In other cases, the complexity and recordkeeping requirements created by enactment of some of the Administration's proposals would outweigh their limited benefits. Thus, to the extent the Administration's proposals are not modified or refined, we believe any improvement in taxpayer perception of the tax system's equity would be offset by increased compliance problems.

Use of allocations to affect income or loss

Contributed property.—Although application of the general allocation rules to appreciated or depreciated property contributed to a partnership can result in a shifting of gains and losses among partners, we believe that mandatory Section 704(c)(2) allocations would impose substantial compliance burdens upon taxpayers.

Effectively, Section 704(c)(2) provides for special allocations of gain, loss, depreciation or depletion with respect to each asset contributed to the partnership. Thus, mandatory Section 704(c)(2) allocations would require partnerships having such property to separately allocate annual depreciation (or depletion) deductions and gain or loss upon sale of the property. Although such a requirement is manageable when only a few items of property have been contributed to a partnership, the task becomes burdensome if there are more than a few items.

Further, this proposal would require determination of fair market value at the time of the contribution. This may not be a difficult task for a two-person partnership when one partner contributes cash and the other contributes property. Yet, when all of the parties contribute property or when one partner contributes several pieces of property, determining the fair market value of such property will be considerably more difficult. Presumably, fair market value may be determined by arm's-length negotiation among the partners or good-faith valuations. Negotiation and valuations concerning fair market value, regardless of now well performed, inevitably can result in factual disputes with the Internal Revenue Service. Mandatory Section 704(c)(2) allocations, therefore, will increase the compliance burden and uncertainty of allocations attributable to contributed property, both for taxpayers and the government.

In addition, there are mechanical problems which should be addressed if such a proposal is enacted. For example, how is the allocation of depreciation (or cost depletion) adjusted if additional partners are admitted or a partner sells his partnership interest? In this regard, if the partner who contributes appreciated or depreciated property sells his partnership interest before the partnership recognizes the gain, what adjustments are made?

In summary, while we understand the Administration's concerns, we respectfully suggest that the number of transactions designed to shift income among partners is not significant enough to justify imposing the additional compliance burdens on all affected taxpayers and the government.

Retroactive allocations.—The cash method of accounting inherently allows the taxpayer to control the recognition of income and expense. The Administration considers this flexibility to be inappropriate when a partnership is formed, because it allows the deferral of partnership deductions until after admission of all of the partners by delaying payment of expenses. Similarly, the Administration is concerned about situations in which there are changes in partnership sharing ratios for profits, losses, credits, etc.

Even though the Administration's concern is understandable, we are troubled by the proliferating complexity of special accounting methods for specific situations and items. The emergence of these special methods not only requires taxpayers to identify those situations when a special is required, but also requires taxpayers to integrate that method into their general method of accounting. Thus, the proposal complicates recordkeeping requirements by requiring taxpayers to compute deductions using their overall method of accounting, but allocate certain deduction items using the accrual method of accounting. (For additional discussion of this problem, see the preface to our comments on accounting reforms.) Nonetheless, further consideration of the appropriateness of capitalizing pre-admission expenses should be considered in abusive situations.

The Administration also proposes to codify the Internal Revenue Service's position in Rev. Rul. 77-311, 1977-2 C.B. 218, with respect to income and loss recognition in tiered partnerships. We believe such action is appropriate.

Use of partnerships to convert character of income or deductions or to defer income

Contributed property holding period.—With respect to the Administration's proposal regarding the income tax character of assets contributed to a partnership, our concern is with respect to the length of the proposed holding period for property other than unrealized receivables. The five-year period currently being considered is significantly longer than the period provided under the gain attribution rules of Sections 644 and 1374. A shorter period would seem to accomplish the desired prophylactic effect with less interference with the conduct of the partnership business. Thus, we recommend that a period comparable to that found in Sections 644 (two years) or 1374 (three years) be used.

Organizational fees and other capital expenditures.—We believe the Administration's proposal to require capitalization of those organization or syndication expenses "paid" through an allocation and distribution of partnership income is appropriate.

Disguised sales

The Administration suggests that contributions of property to a partnership with a near simultaneous distribution of cash resembles a sale of property. In cases in which the funds distributed were contributed by other partners, the Administration proposal mandates the correct result.

In those situations in which the funds distributed are acquired by mortgaging the contributed property, the proposal mandates an incorrect result. Under such circumstances, the Administration's proposal would improperly recharacterize a mortgage of partnership property as a sale, even though the contributing partner could clearly have avoided any tax consequences by obtaining a mortgage prior to contributing the property to the partnership. Of course, the Administration's proposal could be drafted to cover mortgages executed with a view towards later partnership contributions. Such a provision would result in poor tax policy, however, by discriminating against persons who traditionally hold property with equity as opposed to debt. For these reasons, we believe the Administration's proposal should not be enacted.

Other partnership proposals

Like-kind exchanges.—The Administration recommends that partnership interests be excluded from the like-kind exchange exception because, in certain circumstances, such exchanges permit taxpayers to avoid recapture in the case of a burned-out tax shelter. In view of the perceived abuse, prohibiting all like-kind exchanges of partnership interests appears overly broad. If safeguards are necessary, consideration should be given to statutorily providing for qualitative and quantitative tests with respect to the underlying assets of the partnership. For example, the statute could require that partnership interests qualify for like-kind treatment only if 80 percent of the assets of both partnerships would qualify for like-kind treatment if directly exchanged.

Extension of at-risk rules to real estate limited partnerships.—The use of nonrecourse financing in the real estate industry is such a widespread practice that modifying the tax treatment of such arrangements could have profound repercussions. Though the tax policy considerations may be clear-cut, the Committee should not lose sight of the effect such action will have on the overall economy. At best, there would only be a temporary lull in the start of new construction while the industry evaluates the effect of the change. What more likely will occur is an extended construction delay as the industry attempts to find other sources of equity capital or awaits increased prices which justify the increased cost and risk. We recommend, therefore, that such drastic changes not be made without careful consideration of the economic impact.

In addition, limiting application of the at-risk rules to publicly traded real estate limited partnerships is not an acceptable alternative because it would discriminate against small investors.

TAXATION OF CORPORATIONS AND THEIR SHAREHOLDERS

Dividends received by corporations

Debt-financed portfolio stock.—The purpose of the 85 percent dividends-received deduction is to mitigate the effect of a nonintegrated corporate-shareholder tax system. The double level of taxation could otherwise expand to three or more levels of taxation on corporate earnings and their intercorporate distribution. Yet a corporation should not be able to obtain the unintended benefit of both the 85 percent dividends-received deduction and the deduction for interest on debt incurred in an acquisition that lacks investment motive.

Though the law should be modified to prevent this unintended benefit, dividends on stock held for investment should continue to qualify for the 85 percent dividends-received deduction. So long as the stock investment is for a duration that subjects it to market risk, investment intent would be evident. If an investment satisfies an objective test of intention, as demonstrated by the holding period, then the method of financing the investment should be irrelevant.

Accordingly, we believe that last fall's proposal by the Staff of the Senate Finance Committee that stock must be held for at least one year (the long-term capital gain holding period), rather than 15 days (or 90 days for certain preferred stock), to qualify for the dividends-received deduction should be applied in a modified form to leveraged stock investments. See "The Reform and Simplification of the Income Taxation of Corporations," Sen. Finance Comm., September 22, 1983, p. 78. When stock is held for less than one year, the dividends-received deduction would be reduced by the deduction for interest on debt to the extent that, but for the stock investment, the related indebtedness would not have been incurred. As previously set forth in our testimony before the Senate Finance Committee on October 24, 1983, to further mitigate the effect of our system of taxing the same earnings when earned and at every level of subsequent distribution, the dividends-received deduction should be increased from 85 percent to 100 percent.

Extraordinary dividend received by corporations.—The proposal to reduce a corporate shareholder's basis in stock, unless the stock is held for more than one year, by the fair market value of extraordinary dividends raises several questions. First, proper tax policy should permit the amount of the stock basis adjustment to be added to the basis of the distributed property. Therefore, concern may be raised as to whether this proposal could effectively resurrect partial liquidation treatment as it existed prior to TEFRA for corporate shareholders holding the stock for one year or less.

Second, the proposal is unclear as to whether the post-distribution holding period is included for purposes of the one-year test. Given that many extraordinary dividends are unknown at the time of stock purchase, it would appear that a harsh result would occur unless the entire holding period is included. When a corporate shareholder has held the distributing corporation's stock for one year or less at the time of distribution, but thereafter continues to hold it until the holding period exceeds one year, this should result in a reinstatement of the basis reduction initially made.

Ordinary nonliquidating dividend of appreciated property

A general principle in our tax system is that unrealized appreciation is not taxed. Certain exceptions exist, but generally no tax is extracted until an economic benefit is obtained. The imposition of tax usually follows the flow of money, so there is no taxation when there is no wherewithal to pay.

The Administration proposal and other possible proposals suggested in the hearing pamphlet, are similar, in part, to the proposal suggested last fall by the Senate Finance Committee Staff. See "The Reform and Simplification of the Income Taxation of Corporations," Sen. Finance Comm., September 22, 1983, p. 76. As we previously testified at the October 24, 1983 hearing on this subject, we would support the repeal of *General Utilities & Operating Co.* v. *Helvering*, 296 U.S. 200 (1935), if such repeal were coupled with modified integration of the two-tier system of corporate-shareholder taxation.

We believe the Administration proposal to tax the distributing corporation on any ordinary, nonliquidating distribution of appreciated property—with the continued exceptions of present law, including carryover basis on distributions to corporate recipients—would create an extremely complex administrative problem. Specifically, the distributing corporation, in order to determine its tax, would have to determine how much of the distribution was to corporate versus noncorporate shareholders. This would require inordinate (if not impossible) recordkeeping about the identify of its shareholders.

With respect to the possible additional proposal to eliminate the exception of present law covering carryover basis transactions (Section 311(d)(2)(A)), the existence of carryover basis under Section 301(d) would be effectively eliminated. Consequently, gain recognized would result in a basis adjustment to fair market value for corporate recipients.

The possible additional proposal to impose a five-year historical shareholder requirement for corporate distributees in Section 355 transactions would result in different tax results to distributing corporations based upon the distributees. There would be differing tax results depending on whether a corporate shareholder has a less-than-five-year holding period or more-than-five-year holding period. Administrative complexity would result from this provision, as corporations distributing stock in Section 355 transactions would need to know the identity and holding period of all distributees, including those holding stock in a brokerage street name.

Short sale transactions

While we are in agreement with this proposal, we are concerned from a policy standpoint with the precedent resulting from characterizing deductible payments in connection with short sales as interest for purposes of Sections 163(d) and 265.

It should also be noted that under present law there is no Section 212 deduction of the payment in lieu of a dividend for purposes of the alternative minimum tax without having to resort to a recharacterization approach. This payment, however, is not necessarily made from borrowed funds; it could be made from the short sale proceeds or other equity. In the latter situation, no interest has to be incurred to make this payment.

The characterization of this payment as "interest" for purposes of Sections 163(d) and 265 would increase the complexity of current law. This paymeft is already an investment expense under Section 163(d)(3)(C), which reduces investment income for purposes of the limitation thereunder. To treat the paymelt as interest, so that its deductibility is limited to investment income less investment expenses (including such payment), is overly circular and complex.

The treatment of deductible payments in lieu of dividends as interest for purposes of Section 265 merely increases the task of trying to comply with one of the most difficult tasks—tracing the source of funds. Thus, it is our opinion that little benefit would arise from treating deductible payments in lieu of dividends as interest for purposes of Section 163(d) or Section 265, given its present treatment under the alternative minimum tax and Section 163(d).

Transactions in stock warrants

We agree that a simple, symmetrical rule should be adopted regarding the lapse or reacquisition of stock warrants. Because the American Bar Association proposal does not deal with losses, its adoption would create inconsistent rules for gains and losses. Because warrants are similar to stock, we suggest that the alternative possible proposal that no gain or loss be recognized to a corporation on any transaction with respect to an option to buy or sell its stock be adopted.

Earnings and profits

Nontaxable ordinary distributions.—As we previously testified on October 24, 1983 at the Senate Finance Committee hearing on the Reform and Simplification of the Income Taxation of Corporations, the concept of earnings and profits ("E&P") is unduly complex and, in many instances, administratively out of hand. We would not favor the repeal of E&P as the determinant of the amount of taxable dividends unless the repeal is coupled with the adoption of a modified form of corporate-shareholder integration to alleviate the further burdensome effect of our two-tier system of taxation. Absent this modification of our present system of corporate-shareholder taxation, we suggest that a more specific definition of E&P be adopted.

The alternative proposal to redefine E&P to more nearly resemble "economic income" needs to be carefully evaluated in its scope. An economic income concept can be radically different from the general concepts of income realization and recognition, and ability-to-pay, which underlie our whole system of taxation. If "economic income" means "financial earnings," the understanding of the full impact of the use of this concept on the financial community and upon financial reporting would require further exhaustive study. This study would have to take into account the effect, if any, that would result from the rules and regulations of the Securities and Exchange Commission and pronouncements by the Financial Accounting Standards Board. If "economic earnings" means something other than "financial earnings," the concept may well be even more nebulous and elusive than E&P is currently. While time does not permit an in-depth comment on each of the specific possible additional changes to E&P, we do not favor any departure from the general tax concepts of realization and recognition in order to modify the E&P rules governing such items as installmelt transactions, unrealized appreciation on distributed property, and bad debt reserves.

Distribution of debt by a corporation.—As we previously testified on October 24, 1983 at the Senate Finance Committee hearing on The Reform and Simplification of the Income Taxation of Corporations, we believe Section 312 should be amended to deal with this issue by providing for the reduction of E&P only when payment is made on the note. Such payments should be taxable as dividends, regardless of to whom paid.

Redemptions through use of related corporations—corporate shareholders

Whenever possible, the policy that similar transactions will be accorded similar treatment, irrespective of the status of the taxpayer, should be adhered to. If there is a deemed corporate transaction that has the effect of a dividend, all shareholders (although different) should be treated as receiving a dividend. Section 304 treatment does not fall into the category of unintended benefits similar to debt-financed portfolio stock. Consistent tax policy suggests that Section 304 not be limited to only those taxpayers from whom its application potentially extracts the highest tax.

Distributions in liquidation

This possible proposal limits its application to ordinary income property and thus would not involve the complete repeal of *General Utilities,* supra. Any further application of a piecemeal approach to repealing *General Utilities* should be considered only after a comprehensive study of our two-tier system of taxation and the possibility of adopting a modified form of integrating corporate and shareholder taxes.

FOREIGN TRANSACTIONS

Institution of withholding system on the sale of U.S. real property by foreign persons

The Administration's proposal would allow replacement of the information reporting system with a withholding system. The institution of withholding would achieve the objectives of the FIRPTA rules in a simpler and more effective manner than the complex reporting requirements. To avoid applying these overseas requirements to relatively small transactions having relatively small tax potential, we urge that withholding be required only when the sales price is more than a significant amount, e.g., $1,000,000.

Transfers of appreciated property to foreign corporations

Modifications to section 367.—The Administration proposal would amend rules governing transfers of property abroad to provide that gain will be recognized upon the transfer of appreciated property to a foreign corporation which is not for use in an active trade or business outside the U.S. and abandon the current "principal purpose test". We feel that the abandonment of a subjective test such as the "principal purpose test" is a move in the right direction. However, focusing alternatively on an active trade or business test could result in the same subjective, and likely inconsistent, treatment. The "active trade or business test" would be appropriate if such a test were specifically defined in the Code and was not in the nature of the same restrictive case and IRS ruling test applied in Section 355 transactions. Application of such a restrictive test as found in Section 355 would make compliance therewith extremely difficult if not impossible, particularly in newly formed foreign subsidiaries in the start-up stage of operations. Denying tax-free treatment to such transfers would put U.S. taxpayers at a distinct disadvantage versus the foreign competition.

The application of the active trade or business test to the transfer of stock, assuming a look-through approach to the activity of the transferred corporation, again would be reasonable under two circumstances. First, as indicated previously, the active trade or business test must not be overly restrictive, and, second, favorable consideration must be given to the transfer of less than a controlling (80%) interest. Denial of tax-free treatment to transfers of stock that represent a significant ownership interest in a foreign company, as distinguished from a portfolio investment in a foreign company, would be patently unfair. Transfers of stock in foreign subsidiaries to foreign holding companies is usually not motivated by U.S. tax considerations. A frequent reason for such transfers is legitimate reduction of foreign taxes. For example, a U.S. parent with two first-tier U.K. subsidiaries may want to put one under the other or put both under a U.K. holding company to take advantage of the U.K. equivalent of filing consolidated returns. There are similar affiliation requirements for consolidated reporting in other countries such as Germany and the Netherlands. The affiliation requirements in these countries vary, but can go as low as a 50 percent interest.

To the extent there is concern that shares are being transferred to another foreign corporation to avoid U.S. tax on gain from the sale of the transferred shares, we recommend enactment of a provision similar to Section 644 (for transfers of appreciated property to a trust). Under this provision, the transferor would be taxed if the transferee sells the stock within two years of the transfer, to the extent the gain is not otherwise taxed under the Subpart F or foreign personal holding company provisions.

Transfers of intangibles for less than full consideration.—The treatment of intangibles in this manner may be too restrictive and provide an unnecessary disincentive to U.S. businesses planning to expand overseas. Requiring a U.S. corporation to recognize income on the transfer of the intangibles before any income is derived (and which may never be) is unreasonable. Furthermore, the valuation of the consideration to be received for the intangibles transferred would also appear to be extremely difficult, particularly because in most instances the intangibles would not have been used in a trade or business overseas prior to the transfer. In certain countries (e.g., Brazil) no tax deduction is allowed for royalties paid by a local subsidiary to a foreign parent corporation. Thus, if a U.S. corporation decides not to transfer the intangibles so that the requirement to recognize U.S. tax on the transfer could be avoided, it would be required to recognize a royalty under Section 482, which will not be deductible for tax purposes in the foreign country. The issuance, actual or constructive, of full value shares of stock in exchange for intangibles as is currently the case should be adequate in conjunction with the proposed active trade or business requirement. The current taxation of unearned contingent operating income places U.S. taxpayers, particularly those entering into joint ventures with foreign investors, at a distinct economic disadvantage.

Incorporation of foreign branches.—The proposal favors adoption of the present IRS ruling policy on incorporation of foreign branches. This proposal would codify the rule of Rev. Rul. 78-201, 1978-1 C.B. 91, and its progeny, which requires the recapture of prior foreign losses of a loss branch as a toll charge upon its incorporation to the extent that the fair market value of the branch assets exceeds the adjusted basis in those assets. Codification of Rev. Rul. 78-201 would reverse the current rule in Section 904(f)(3) under which recapture of branch losses is required only to the extent there is an overall foreign loss which has not previously been recaptured by resourcing foreign source income as U.S. source income for purposes of the Section 904 foreign tax credit limitation. Whereas, Section 904(f)(3) in effect assumes that foreign source losses first offset foreign source income, Rev. Rul. 78-201 in effect assumes that foreign source losses offset U.S. source income. Section 904(f)(3) is consistent with the overall policy of Section 904(f), which assumes foreign losses offset foreign source income first. If any action is required at this time, it should be to emphasize that Rev. Rul. 78-201 is incorrect.

We also would like to point out that because all limitations on tax-free transfers under Section 367 will apply prospectively only, the effect is to put new and emerging companies that are contemplating overseas operations at a disadvantage in competing with established multinational companies.

Replacement of DISC with foreign sales corporation (FSC)

The proposed Foreign Sales Corporation Act is receiving widespread support among U.S. firms engaged in exporting as a potential replacement for the current DISC provisions. We enthusiastically support the proposal, subject to the following considerations:

(1) It is essential that accumulated DISC income not be subject to any future taxation. We understand that the GATT feels that this would also be an illegal export subsidy; nevertheless, taxation of the accumulated deferrals would be inequitable and pose a serious hardship on all taxpayers with DISCs.

(2) The foreign presence and foreign economic requirements should be further challenged and reduced to the minimum necessary to satisfy the GATT requirements. The additional cost and administrative burden of the need for a foreign presence and the excessive foreign economic requirements should be minimized to assure parity between the FSC and the DISC Provisions. A liberal interpretation of the use of agents by a FSC should be emphasized in the legislation.

(3) More legislative guidance should be included as to how a commission FSC may operate. Too much discretion is currently left with Treasury to issue regulations. Many companies have not been fully able to appraise the proposal. Because most companies operate commission DISCs, they probably would prefer to have commission FSCs, which presumably would be easier to use.

(4) A FSC should not be taxed separately. Under current law, tax arising from a DISC dividend may be offset by the parent company's losses and credits. Under the proposal, a FSC must pay tax on its nonexempt income even if the parent has tax credits or losses. Perhaps treating the nonexempt FSC income as a deemed dividend to the shareholder would solve the problem.

TIME VALUE OF MONEY AND OTHER ACCOUNTING ISSUES

A number of the Administration's "accounting reform" proposals would place taxpayers on a hybrid method of accounting for tax purposes: cash basis for certain transactions and accrual basis for others, regardless of the taxpayer's chosen overall method. In attempting to limit the "unintended" tax benefits of prepayments and long-term accruals, among others, these proposals further blur the distinction between the cash and accrual methods of accounting. These two overall methods originated, in part, because they embody accepted accounting procedures, and thus their standard sets of rules can be consistently applied to transactions encountered by the taxpayer. The Administration's proposals now move the taxpayer closer to an accounting method based upon the later of the cash or accrual method for deductions and the earlier of the cash or accrual method for income. The lack of symmetry is striking. A taxpayer could be forced to immediately accrue income on one side of the transaction, but required to delay the corresponding deduction on the other side of the transaction.

The effect of these proposals on transactions in the ordinary course of business, as opposed to "abusive tax shelters," will be pervasive and disruptive. We would caution against the introduction of new hybrid methods of accounting, that would complicate rather than simplify the tax code. We recommend that Congress fashion proposals to end the perceived "abuses" without disrupting the foundations upon which transactions in the ordinary course of business are conducted. Proposals that are narrowly targeted toward the selected "abuse" areas are preferable by far to broad-based proposals encompassing a vast majority of transactions conducted in the ordinary course of business.

Prepayments of expenses

The Administration's proposal would deny deductions to syndicates for prepaid expenses prior to the period to which the expenses are allocable, regardless of whether the syndicate is using the cash or the accrual method of accounting. This proposal challenges the very nature of the long-standing principles underlying the cash and accrual methods of accounting. A new hybrid method of accounting is created for certain taxpayers having a deduction for prepaid expenses. These expenses may be deducted only over the periods to which they are allocable. This appears to be the case even when the taxpayers receiving the prepaid expenses are required to report those amounts upon receipt. See, e.g., Treas. Reg. § 1.61-8(b) (prepaid rent); Rev. Proc. 71-21, 1971-2 C.B. 549 (certain service income); Treas. Reg. § 1.451-1(a) (items generally included in income in year of receipt unless includible for a different year in accordance with the taxpayer's method of accounting).

We believe that the Administration's proposal would have wide application beyond the "abuse" situations for which it is apparently intended. For example, research and development partnerships would be covered by this prepayment rule. Yet these partnerships generally result in less than a one-to-one write off and are highly effective in promoting the development of the high-tech research so necessary to the production of new jobs in the U.S. economy.

In addition, this proposal would force many cash basis taxpayers to keep much more extensive records. One of the basic principles underlying the cash method of accounting is its simplicity. It is this simplicity that appeals to many small businesses, that otherwise would have to devote time and effort to keeping extensive records for their normal business activities.

Accordingly, we recommend that the proposals be narrowed to a point where the abusive situation is corrected, but where most taxpayers entering into transactions in the ordinary course of their business are exempted. Present law already prevents a deduction when an expenditure results in the creation of an asset having a useful life substantially beyond the end of the taxable year. Treas. Reg. § 1.461-1(a)(1)-(2).

If the proposal were adopted, we would suggest that the committee exempt prepayment situations when the period to which the expenses are allocable is the year following the year of payment. In other words, the proposal should affect only those prepayments that are allocable to years following the year subsequent to the payment. A similar rule has been applied to exempt from immediate recognition the receipt of service income by an accrual basis taxpayer where the services are to be performed by the end of the taxable year following the taxable year of receipt. Rev. Proc. 71-21, 1971-2 C.B. 549. As another suggestion, we recommend that the definition of "syndicate" be narrowed to exclude entities such as research and development partnerships.

Interest-free loans

Prior to *Dickman* v. *Comm'r.*, (2/22/84), there was a substantial body of case law permitting interest-free loans without tax consequences. In *Dickman*, the U.S. Supreme Court held that the loan of interest-free funds results in a taxable gift of the use of such funds, but it did not address the issue of income from the interest-free loan. Because of the long-standing, precedent-setting cases on which many taxpayers have relied for no income recognition, we would recommend that either (1) existing interest-free loans be grandfathered with respect to any change in these principles, or (2) a year, such as 1988, be set after which the Administration's proposals would apply to all then-existing interest-free loans.

$10,000 exemption.—The $10,000 exemption for interest-free loans in the services-related area would appear to be unduly low when interest-free advances are made in the ordinary course of business and are not meant to be in the nature of compensation. The self-cancelling nature of the imputed income and expense items and the additional recordkeeping because of this proposal appear unwarranted except in related party transactions. Accordingly, a more substantial safe-harbor loan amount, such as $100,000 for all business loan situations, should be considered.

Advanced compensation.—In certain industries, it is customary to make advances to employees to cover their expenses in the performance of the employer's business. Advances to salesmen, insurance agents, and similar types of advances are examples of such industry practices. These generally are not loans but are meant to be advances against income to be earned contemporaneously or shortly thereafter. They usually become loans only if the employee ceases employment without having earned enough to cover the advances. We believe that the Administration's proposal should apply, if at all, only to these advances at the time they are actually converted to loans.

Section 163(d).—The Administration's proposal would impute income to the lender and would allow an interest deduction to the debtor. The deduction of this "interest" by the debtor would be limited by the Section 163(d) rules, which generally limit the amount of an interest deduction by an individual to $10,000 plus the amount of the individual's net investment income. Such a system typically favors wealthier individuals who usually have a greater amount of net investment income, which consequently raises the limit on their interest deduction. In contrast, a more moderate income taxpayer may not have the net investment income necessary to raise the Section 163(d) limitation to a point where all of the interest could be deducted.

Deferred like-kind exchanges

In view of the administrative problems in monitoring a transaction that can be completed in up to five years (see, e.g., *Starker* v. *U.S.*, 602 F.2d 1341 (9th Cir. 1979)), the Administration's proposal to require the completion of a like-kind exchange within a shorter period is justified. The 90-day period, however, may be unrealistic for many legitimate business transactions. As an alternative, we suggest requiring that the exchange be concluded by the extended due date of the tax return for the year the initial transfer was made. Thus, on the same tax return the taxpayer would report both the disposition and the acquisition of like-kind properties. Such an approach would ease the burden of monitoring like-kind exchanges and permit a more realistic period, in most instances, for completion of the exchange.

LIFO conformity

The Administration's proposal seeks to overturn the result in *Insilco Corp.*, 73 T.C. 589 (1980), aff'd in an unreported decision (2d Cir. 1980), wherein a parent company was allowed to restate the LIFO inventories of its subsidiary in reporting to the parent's shareholders, without violating the LIFO conformity rules. We question whether this is truly an "abusive" situation in light of the current trend toward relaxation of the LIFO conformity rules.

The LIFO conformity requirement, found in Section 472(c), was enacted in the Revenue Act of 1939 with the intention that the use of LIFO for tax purposes would conform, as nearly as possible, with the best accounting practice in the trade or business in order to provide a clear reflection of income. The conformity requirement was first liberalized in the Revenue Act of 1942, which made it clear that the conformity requirement did not apply to interim reports or financial statements. Since then, the conformity requirement has undergone a number of liberalizations, especially when it has conflicted with the Securities and Exchange Commission disclosure requirements. See, e.g., Rev. Proc. 75-10, 1975-1 C.B. 651; Rev. Proc. 77-7, 1977-1 C.B. 540; Rev. Rul. 79-58, 1979-1 C.B. 187. Finally, in recognition that LIFO is accepted as a proper or even the "preferred" method of accounting and that it clearly reflects income, the Treasury's own regulations generally limit the applicability of the LIFO conformity requirement to the primary income statement. Treas. Reg. § 1.472.-2(e).

Further, the Internal Revenue Service itself stated in Rev. Rul. 69-17, 1967-1 C.B. 143, that the conformity requirement was not violated when an affiliated group used the FIFO method of valuing the inventory of a subsidiary member in preparing consolidated financial statements for credit purposes and for reporting to its shareholders, even though that subsidiary member used the LIFO method for Federal income tax purposes. This is substantially the same situation as that which occurred in *Insilco*. A little over a year later, the Internal Revenue Service reversed itself by revoking Rev. Rul. 69-17 for consolidated returns issued subsequent to August 31, 1971. Rev. Rul. 70-457, 1970-2 C.B. 457.

If the Internal Revenue Service is concerned that the *Insilco* decision provides a mechanism for organizing a holding company merely as a device to circumvent the LIFO conformity requirement, we would point out that the IRS already may attack any such situation within the context of "substance vs. form" or "sham transaction." As the court noted in the *Insilco* case, the IRS already has many tools in its arsenal. See *Gregory* v. *Helvering*, 293 U.S. 465 (1935); *10-42 Corp.*, 55 T.C. 593, 598 (1971).

If legislation is enacted in this area, we agree with the proposal that it should not apply to a foreign parent company's financial statements which include the results of operations of its U.S. subsidiary corporation using the LIFO method.

Premature accruals

Lack of symmetry.—The Administration's proposal provides that no deduction would be allowed until economic performance occurs. This is not the case on the gross income side, however. Under generally established tax and accounting principles, an accrual basis taxpayer must take a receivable into income when it has the unrestricted right to that income. This is true even though economic performance (actual receipt) may not occur for a number of years. For example, interest income will accrue yearly to an accrual basis lender even though that interest may not be paid until the loan is finally due.

Hybrid method of accounting.—The Administration's proposal introduces yet another hybrid method of accounting that goes against the grain of long-standing tax and accounting principles. In its intent to eliminate "abusive" tax shelters, this proposal would affect countless other taxpayers conducting transactions in the ordinary course of their business. This new hybrid method would not provide for an accurate measurement of income. Under the annual accounting concept, there is a matching of liabilities (expenses) to the income to which they relate. Under the Administration's proposal, the delayed recognition of these liabilities (expenses) would overstate current income and would not show a matching of income and liabilities (expenses). The Administration's proposal would carry the taxpayer's accounting method further away from the principles of matching income with related liabilities (expenses) and providing an overall clear reflection of income. For the above reasons, we would recommend that Congress not adopt the Administration's proposal.

Five-year rule.—If the Administration's proposal is adopted, we would recommend that the proposal not apply to accrual situations in which economic performance occurs within five years of the accrual of the liability. This modification would address the "abusive" situations, but would exempt the many nonabusive situations generally occurring in the ordinary course of a taxpayer's business—especially in the case of a small business taxpayer whose bookkeeping procedures would be disrupted by the Administration's proposal. We recommend that the proposal provide a safe harbor and not apply to accrual situations within a five-year period.

Election.—We would also recommend that accrual basis taxpayers be provided an election whereby an accrued liability could be deducted upon accrual if the taxpayer to whom the liability is owed accrues the amount of the liability into the same year's income. In this situation, the potential for abuse or revenue loss would be substantially minimized, irrespective of the taxpayers involved.

Regulatory area.—With respect to long-term obligations in excess of five years, not subject to symmetry between paying and receiving taxpayers, such as in the regulatory area, amortization of the obligation over the period benefited would be appropriate.

Premature employer contributions to benefit plans

Voluntary Employees' Beneficiary Association (VEBA).—The proposals set forth in this section appear to address two basic concerns: (1) the use of a VEBA in the case of a closely held employer primarily as a tax-shelter vehicle for its owner-employees; and (2) the use of a VEBA as a funding vehicle for certain benefits that may nominally qualify as welfare benefits but actually are more equivalent to deferred compensation.

We believe that these proposals are much more complex than required to provide a remedy for the above stated problems. Rather, we believe that the first concern, involving the limited membership VEBA, can be addressed simply by providing a rule that would preclude the allocation of a dominant share of benefits provided annually under a VEBA to members of the "key employee" group. For example, the proposal calls for a cap of 25 percent of the overall benefits that may be provided to officers, owners, or highly compensated employees.

The second stated concern, regarding the use of VEBAs as funding vehicles for so-called welfare benefits that are actually more akin to deferred compensation programs, also can be resolved with the provision of a clear line of demarcation between the indicia of a welfare benefit plan versus that of a deferred compensation plan. In defining the permissible benefits that may be provided under a VEBA, those benefits characterized as deferred compensation would simply be disallowed. This would eliminate the need to introduce a totally revised set of rules covering the timing of deductions for employer contributions to VEBAs.

Definition of deferred compensation.—Our suggestion would be to define a welfare plan as one which provides benefits that are instituted primarily to ensure the well-being of the participating employee group. In contrast, a plan of deferred compensation would be defined as a plan that provides benefits that are essentially equivalent to additional salary or that are intended as a supplement to the employee's basic retirement benefits. Thus, for example, non-vested severance pay benefits that are payable solely by reason of voluntary termination of service and cease upon acceptance of other employment by the employee would be considered a welfare benefit. In contrast, vested severance pay benefits that are payable upon termination of employment—whether voluntary or involuntary—or upon attainment of early or normal retirement age, would be characterized as a deferred compensation benefit. Because vacation pay is intended primarily to provide time off from work and not as a supplement to the employee's annual salary, it should be considered a welfare benefit. The fact that some deferral of income may be involved under a vacation plan that permits employees to roll over unused vacation days into the next year does not detract from the primary objective of the plan, i.e., to provide for vacation time.

DEBT OBLIGATIONS ACQUIRED AT A DISCOUNT

Market discount on debt obligations

The Administration's proposal assumes that market discount is solely attributable to interest rates. Yet a variety of factors affect a bond's valuation, e.g., the post-issuance changes in the financial strength of the debtor. In addition, the Administration's proposal results in a lack of symmetry in the treatment of the seller and the purchaser. Whereas the seller recognizes a capital loss as a result of any decline in value, the purchaser may recognize a recovery of this amount as ordinary income. Accordingly, from a policy perspective, we believe the Administration's proposal is inappropriate.

Mr. **GIBBONS**. Mr. Rosenthal.

STATEMENT OF JEFFREY R. ROSENTHAL, PARTNER, PEAT, MARWICK, MITCHELL & CO.

Mr. **ROSENTHAL**. Mr. Chairman and members of the committee, my name is Jeffrey Rosenthal.

Mr. GIBBONS. You have to get real close to the microphone, Mr. Rosenthal. They're not very good.

Mr. ROSENTHAL. Thank you.

My name is Jeffrey Rosenthal. I'm a partner in the public accouting firm of Peat, Marwick, Mitchell & Co. from Chicago. I am here to testify on behalf of my clients in the real estate industry.

I have restricted my testimony today to the provisions regarding retroactive partnership allocations and the provision or the proposal relating to the deductibility of prepaid expenses.

The provisions relative to retroactive allocations come in two pieces or in two separate issues. The first is relative to allocations made by tiered partnership structures.

It has been my opinion, my clients' opinions, and the IRS opinion that the allocations to which this proposal would relate have been prohibited since 1976, and therefore to the extent that it would clarify present law or close a loophole within present law, I strongly agree.

The second proposal on retroactive allocations relates to cash basis partnerships and how they would allocate taxable income or loss, to partners who were newly-admitted during the taxable year.

In this case, I oppose the proposal for the following reasons:

First, it adds complexity to the tax law, increasing taxpayer compliance burden and IRS administrative burden.

Second, it would cause allocations which would have less substantial economic effect than the allocations that it would intend to prohibit.

Given the importance of substantial economic effect in all partnership allocations, I would think that any provision that causes less substantial economic effect would be contrary to tax policy today.

Third, this provision would cause a discrimination against the use of partnerships as a form of doing business because a person making a direct investment in a property would not be covered by the provision at all.

It would also possibly cause discrimination against taxpayers who do not have the means to make an investment on their own because their unlimited means would be required to be pooled with other investors, such as people that invest in publicly-held limited partnerships.

In addition, I do not believe that this provision would cause significant increments to Federal tax revenues. This is an allocation provision. It does not create additional taxable revenues, nor does it disallow tax deductions. Consequently, I do not think that revenues would be generated to offset things that I previously spoke of.

Last in this area, I would like to correct what I think is a misinformation relative to the testimony given to this committee on February 22. On that date, it was implied that interim closings of partnership books are contrary to the intent of the Tax Reform Act of 1976. The report of this committee and the Senate Finance Committee indicate that interim closings were intended, even in situations where there would be more tax benefits allocated to a newly-admitted partner.

In the area of prepayments, the administration proposal would disallow deductions for prepaid expenses by syndicates.

I would propose to modify the administration's proposal for the following reasons:

One, it again is an attack on the cash basis of accounting which is the least complex method, and would cause additional complexity, additional burdens on taxpayers, additional burdens on the IRS from an administrative standpoint.

Second, it could, or it even maybe would, cause different accounting for items that are normally prepaid within today's economy, such as real estate taxes in some States, insurance premiums, and maintenance and management contracts.

I would not think that causing additional accounting burden relative to the many, many transactions that are normally priced and normally done on a prepaid basis would be in the best interest of this legislation.

Further, most of these prepayments are not the result of seeking tax benefit, but are the result of just normal business practices.

Finally, this provision would also discriminate against limited partnerships or partnerships as a form of doing business, and perhaps against those taxpayers who do not have the means to invest otherwise.

Finally, this proposal ignores a rule that has been informally adopted among the courts, a 1-year prepayment rule. It would seem to me that the 1-year prepayment rule would certainly avoid most of the material distortions with which the administration is concerned.

Consequently, I would propose to amend the administration's proposals to adopt this 1-year rule, and thereby achieve most of the administration's concerns in this area, while still allowing normal accounting practices to follow normal business practices.

Thank you.

Mr. GIBBONS. Thank you, sir.

[The prepared statement follows:]

STATEMENT OF JEFFREY R. ROSENTHAL, PEAT, MARWICK, MITCHELL & CO.

Mr. Chairman Rostenkowski and Members of the Committee:

It is a pleasure to testify before the Committee regarding certain current proposals relating to tax shelters and other tax-motivated transactions. My name is Jeffrey R. Rosenthal. I am a partner in the public accounting firm of Peat, Marwick, Mitchell & Co. in Chicago, Illinois. I am here to testify before the Committee on behalf of my clients in the real estate investment industry. I am limiting my testimony to the proposals regarding the allocations of taxable income or loss by partnerships which have been characterized as "retroactive allocations" and the proposal relating to the deductibility of prepaid expenses.

ALLOCATIONS OF TAXABLE INCOME OR LOSS BY TIERED PARTNERSHIPS

Based upon the current Administration proposals, it would appear that some taxpayers have taken the position that when an investor indirectly acquires an interest in a "subsidiary" operating partnership through an acquisition of an interest in a "parent" partnership (a so-called "tiered" partnership structure), the taxable income or loss of the subsidiary operating partnership is deemed to be earned or incurred by the parent (and its partners) on the last day of the subsidiary partnership's taxable year. This position would allow such partnerships to allocate a distributive share of the subsidiary partnership's taxable income or loss for the entire taxable year to any partner admitted to the parent partnership prior to the end of the subsidiary partnership's taxable year.

Section 213(c) of the Tax Reform Act of 1976 amended Section 706(c)(2)(B) of the Internal Revenue Code to require that items of taxable income or loss of a partnership must be allocated to the portion of the taxable year that a partner held his partnership interest, thereby prohibiting retroactive allocations. Based upon the Administration proposal, it would appear that some taxpayers have used tiered partnership structures to avoid the prohibition of retroactive allocations of Section 706(c)(2)(B). Since 1976, my clients and I have been of the opinion that Section 706(c)(2)(B), as presently written, precludes such allocations. Further, the Internal Revenue Service issued the same opinion in Revenue Ruling 77-311, 1977-2 C.B. 218. Consequently, to the extent that the Administration proposal would clarify the present intent of Section 706(c)(2)(B) or would close a loophole within such section, I strongly agree.

ALLOCATIONS OF TAXABLE INCOME AND LOSS BY CASH BASIS PARTNERSHIPS

A second proposal regarding partnership allocations concerns the allocations of taxable income or loss by partnerships using the cash receipts and disbursements method of accounting. Under present law, a partnership is allowed to allocate taxable income and loss to partners with varying interests during the taxable year by use of a pro rata allocation method or an interim closing of the partnership's books, pursuant to Section 706(c)(2)(B) of the Internal Revenue Code and the regulations thereunder. A partnership using the cash method of accounting and an interim clsoing of its books could elect to allocate to a newly admitted partner a distributive share of all income received and deductible expenses paid subsequent to the date of his admission.

The Administration proposal would amend the operation of Section 706(c)(2)(B) to cause expenses incurred by a partnership to be allocated over the taxable year (perhaps on a daily basis) regardless of the time which such expenses are paid. This would prohibit a cash basis partnership from using an interim closing of its books to allocate taxable income or loss among its partners in a taxable year in which the interests of such partners varied. I am opposed to this proposal because it adds complexity to the tax law, requires allocations which often have less substantial economic effect than many of the allocations that it would prohibit, modifies a provision which is coincident with the intent of this Committee and Congress in enacting Section 213(c) of the Tax Reform Act of 1976 (contrary to testimony given to this Committee on February 22nd) and unnecessarily discriminates against the use of the partnership form for conducting business and making investments. Further, this proposal is not a material portion of the Administration's revenue proposals as an offset to the four factors cited above.

First, it should be noted that present law allocations of taxable income or loss by a cash basis partnership using an interim closing of the books is not contrary to either the wording or the congressional intent of Section 706(c)(2)(B), as amended by Section 213(c) of the Tax Reform Act of 1976. On February 22, this Committee received testimony which indicated that the proposed changes regarding tiered partnership structures and allocations of taxable income and loss by cash basis partnerships would "clarify the clear policy against retroactive partnership allocations that Congress adopted in 1976." Both the report of this Committee and the Senate Finance Committee report to the Tax Reform Act of 1976 contain the following wording: "In addition, regulations are to apply the same alternative methods of computing allocations of income and loss to situations falling under Section 706(c)(2)(B) as that currently provided with respect to Section 706(c)(2)(A) situations (sale or liquidation of an entire interest). These rules will permit a partnership to choose the easier method of prorating items according to the portion of the year for which a partner was a partner or the more precise method of an interim closing of the books (as if the year had closed) which, in some instances, will be more advantageous where most of the deductible expenses were paid or incurred upon or subsequent to the entry of the new partners to the partnership." It should also be noted that the explanation quoted above appears consistently in reports of this Committee and the Senate Finance Committee for both the Tax Reform Act of 1975 and the Tax Reform Act of 1976. Consequently, it is apparent that the allocation methods of current law are not contrary to the congressional intent of the Tax Reform Act of 1976 and were, in fact, considered and identified by this Committee and Congress during the two year period of discussion prior to enactment of the Tax Reform Act of 1976.

Second, the enactment of this provision would add complexity to the Internal Revenue Code by elminating one of the few easily understood provisions of Subchapter K. It has long been the goal of Congress to attempt to simplify the income tax law. Although this is not the primary goal of income tax legislation and has not historically been a goal with which Congress has been overly successful it would appear that this proposal would create additional complexity and additional administrative burden in the tax law without creating a significant increase in Federal income tax revenues.

The present law provisions which allow partnerships to use the cash method of accounting and an interim closing of the books is a combination of the least complex method of accounting and the most accurate method of allocating a partnership's taxable income or loss among partners for segments of a taxable year. The proposed change would require a departure from the cash method of accounting, thereby creating an additional taxpayer compliance burden due to the complexity of the subject proposal. Further, the Administration's proposal would create additional administrative burden for the Internal Revenue Service by eliminating a very simple, accurate and easily examined method of allocation.

The increased burden upon both taxpayers and the Internal Revenue Service is not likely to be offset by significantly increased federal tax revenues because allocation provisions neither create taxable income nor disallow deductions. Consequently, unless the partnership allocations described in the Administration's proposal were consistently made to taxpayers with reduced marginal income tax rates, the Federal tax revenues should not be materially increased. The interaction of increased taxpayer compliance burden, increased Internal Revenue Service administrative burden and static Federal tax revenue make this proposal counterproductive to the purpose of the proposed legislation being considered by this Committee.

Third, the Administration's proposal would cause many partnership allocations to have less substantial economic effect than the allocations allowed under present law. In many cases, the proposal would have the effect of diverting a loss away from a partner who had paid for and suffered an economic loss relative to a deductible expenditure. For example, assume that a cash basis calendar year partnership was formed on January 1, 1985 by A and B. A and B each make a $10,000 capital contribution on that date. Through November 30, 1985, the partnership incurs $30,000 of expenses which have not been paid and on December 1, 1985, C becomes an equal partner and contributes $10,000 as payment for a ⅓ share of the partnership. On December 31, 1985, the partership pays the $30,000 of deductible expenses. Under present law A, B, and C could each be allocated an equal share of the partnership's $30,000 taxable loss for 1985, reflecting the economic substance of their transaction. Under the proposal, A and B, having been partners for the entire year, would each be allocated ½ of 334/365 of the $30,000 taxable loss plus ⅓ of 31/365 of the $30,000 taxable loss ($14,575.34 each). C, having been a partner for 31 days of the taxable year, would be allocated 31/365 of ⅓ of the $30,000 loss, or $849.32. This result is contrary to the economic substance of their transaction or, in tax parlance, lacks substantial economic effect.

In 1976, this Committee and Congress enacted legislation requiring most partnership allocations to have substantial economic effect. The importance of this requirement is highlighted by the fact that the Internal Revenue Service and Treasury have spent over seven years considering comprehensive regulations to formalize the Government's position regarding partnership allocations and their required substantial economic effect. Therefore, it would appear that the enactment of any proposal which would cause many partnership allocations to have less substantial economic effect than the options allowed under current law would be an important departure from established tax policy.

Finally, the Administration proposal would create unintended discrimination against partnerships as a form of doing business and making investments as well as discrimination against certain groups of taxpayers who may be limited to making such investments through the partnership form. Many businesses and investments, such as the ownership of real estate, could alternatively be carried on through sole ownership, joint (which may not be a partnership for Federal income tax purposes) and partnerships. The proposal could cause an investor to realize less tax benefits from an investment in a partnership than if he were to acquire his investment directly. For example, consider an investor who purchases an interest in a building commonly referred to as "distressed property," i.e., property that is undercapitalized and which has become economically encumbered by expenses which have been deferred as a result of its undercapitalization. An investor purchasing this property directly would be unaffected by the proposed legislation and would generally realize more tax benefits relative to the payment of these deferred expenses. If the Administration's proposal were enacted, that same investor, investing in a partnership, would not realize the tax benefit of the payment of such deferred expenses because the tax deductions would be allocated to the previously existing partners, those same partners who had allowed the property to become undercapitalized. The limitations imposed by the Administration's proposal would reduce the flexibility which was purposefully included in the Subchapter K, thereby reducing the desirability of the partnership as a form of doing business or making investments. In addition, the Administration's proposal could cause unintended discrimination against taxpayers who would not have the means to make an investment, such as a real estate investment, without pooling their funds with other investors. An example would be the hundreds of thousands of investors who own interests in publicly-syndicated real estate partnerships with large and diversified real estate holdings. These individuals invest as little as $2,000 (directly or through their IRAs) and own interests, small though they may be, in large and often prestigious real estate holdings all over the country. If the partnership form were, as a result of this proposal, to become a less attractive vehicle for conducting business or making investment, then many of these taxpayers may be precluded from making such investments. The effects of restricting or excluding taxpayers of lesser means from the investment process would not be beneficial to this country's economy or to Federal tax revenues.

Based upon the above discussion, I do not recommend the Administration's proposal to modify the current law procedures for allocating taxable income or loss by partnerships using the cash receipts and disbursements method of accounting. Current law is preferable to the proposal because it is less complex, more easily administered, more reflective of the economic effect of transactions among partners and coincident with the intent of Congress in drafting tax law regarding partnerships and allocations among partners.

PREPAYMENTS OF EXPENSES

Current law allows a cash basis taxpayer to deduct expenses in the taxable year in which paid unless the payment of such expenditure creates an asset with an economic life extending substantially beyond the close of the taxable year. In such cases, the deduction relative to such expenditure would be deferred in whole or in part to the taxable years to which the economic benefit of such asset would relate. Generally, the courts have allowed deductions for prepayments of expenses unless such deductions caused a material distortion of taxable income. The courts have informally adopted of a one-year rule, whereby prepayments which do not exceed one year subsequent to the end of the taxable year in which paid would not be considered a material distortion of taxable income.

The Administration has proposed to disallow deductions for prepaid expenses paid in tax-sheltered transactions or by syndicates. I would propose a modification to this proposal because it creates unnecessary complexity in the tax law, ignores an operative rule under present case law which effectively eliminates material distortions of taxable income, requires accounting which differs from many normal business practices and should not create material increments to Federal tax revenue.

The Administration proposal relative to prepayments of expenses is a second attack on the cash receipts and disbursements method of accounting. In this case, the Administration's proposal would increase taxpayer compliance burden and Internal Revenue Service administrative burden. The deduction of prepaid expenses is the most easily understood method of accounting for taxpayers. An Internal Revenue Service audit of a cash payment is much less burdensome on both the taxpayer and the Internal Revenue Service than the examination of each payment to determine the time period to which it relates. Consequently, this proposal would create an unnecessary complication to the accounting method which is predominant within the Federal tax system.

The Administration proposal would also cause tax accounting for cash basis taxpayers to differ from normal business practice relative to large numbers of transactions. Many transactions requiring prepaying in the mormal course of business, such as insurance premiums, management and maintenance contracts, real estate taxes in some states, and dues and subcriptions (among others) woud be subject to more complex tax accounting. In other words, the adoption of the Administration's proposal would add complexity and taxpayer compliance burden relative to large numbers of recurring transactions which are not prepayments due to their Federal income tax benefit but are prepayment due to normal business and pricing practices within the economy. It does not appear beneficial to enact a rule which in many cases causes the accounting for an item to be different than normal business and pricing practices.

It should also be noted that the additional complexity, increased compliance and administrative burden and departure of the accounting from normal business practices should not be accompained by a significant increase in Federal tax revenues. In opeation, this proposal would defer of the deduction of prepaid expenses, not disallow them. Therefore, the only increase in Federal tax revenues would be due to the time value of money. Further, this effect would not be cumulative but would be realized primarily in the year's of enactment.

The combination of increased complexity, increased taxpayer compliance burden, increased Internal Revenue Service administrative burden and little change to Federal tax revenues would make the proposal, as written, contrary to the purpose of the tax legislation presently being considered. It should be noted that the courts have established a rule, the so-called "one-year rule" which prevents the material distortions of taxable income which cause the Administration so much concern. I would, therefore, recommend that the proposal be amended to a one-year prepayment rule so as to achieve the Administration's purpose of prohibiting material distortions of taxble income which may be inherent in the cash receipts and disbursements method of accounting. Further, the enactment of a one-year rule would not cause most accounting to depart from normal business and pricing practices because most repayment are for a period of one year or less.

Mr. GIBBONS. Do my colleagues have questions of this panel?

Mr. FLIPPO. Yes, sir.

Mr. GIBBONS. Mr. Flippo.

Mr. Flippo. I have a question directed to any panel member who would care to address it.

Do you believe that if the committee and the Congress adopts these recommendations as they are presently stated—what do you think will be the response of the business community or the taxpayers that you represent?

Do you think there will be concurrence and approval with these?

Mr. BERENSON. Well, I will make one comment. I think you probably would see another massive step forward to changing the overall system, come 1985, because you'll be putting another layer of staggering complexity upon an already very, very overburdened system. And I think we could well wind up throwing the baby out with the bath water in many ordinary nonabusive business situations.

Mr. ELLENTUCK. I might say that I think that for those proposals that we think properly correct abuses, legitimate practitioners would welcome those, and I think you would see that across the board.

Mr. FLIPPO. And is it your opinion that the proposals, as they are currently made, substantially accomplish that and that alone?

Mr. ELLENTUCK. Well, Mr. Flippo, as I said in my comments, I think that some of the proposals do. They are fair and properly deal with abuses. However, some of them, we think, are unnecessary, since the IRS now has some tools with which to deal with them effectively.

Mr. PADWE. Either unnecessary or, as I pointed out, unnecessarily broad. We understand the way Treasury is going, the way that you people are going, and that makes a good deal of sense, on the whole; but we are concerned about whether or not there is such breadth in many of these proposals; that you are going to hit some people that are absolutely not within anyone's contemplation.

Mr. PILIERO. I would like to comment with respect to investors, as well as the tax community. Our view is that a lot of the problem areas may be narrower than the proposed solutions. There would be a significant adverse impact both on corporations, taxpayers, and on our recovery, if this proposal was adopted. Unless the bill is modified appropriately, the bill would be more destructive than beneficial.

Mr. FLIPPO. Thank you, Mr. Chairman.

Mr. PADWE. Mr. Flippo, if I could just add one thing, particularly in the corporate reform area where——

Mr. GIBBONS. Could you speak a little louder, sir? We're having trouble hearing you.

Mr. PADWE. Yes.

Particularly in the corporate reform area, the subchapter C area, where there are very, very pervasive changes being suggested now, but where we know that a great many more are still to come, that the approach of doing one bit now in one bill and something more in another bill is a very, very difficult one. I think many corporations are going to find themselves not only confused, but disadvantaged by this type of approach, and I do not mean that in narrow terms. They just would not know what to do, how to plan.

Mr. PILIERO. I would comment, sir, also on a proposal offered by Senator Moynihan this morning which, of course, is under consideration.

Some of the proposals there, while sweeping and facile in their suggestion, would be very destructive and, in our view, require a great deal more study before this committee could or should endorse them.

We are not at all convinced—I think there is a study proposed at the end of the Senator's bill. We would recommend that before the bill and many of its provisions be supported, a great deal more study be done, not necessarily in a formal way, but in an informal way. The bill seems to be coming from a perspective that we are unfamiliar with.

Thank you.

Mr. GIBBONS. Mr. Pease.

Mr. BERENSON. Any of those steps that do correct the perceived inequities and the real inequities in the system you can target—and that can be done, especially in the areas of abusive shelters I think there is almost like unanimous support behind that concept.

But when it is done with a shotgun approach rather than a rifle, I think then we damage the entire system at a price beyond the benefits we derive from those specific abusive areas we have corrected.

Mr. FLIPPO. Well, I would just observe the obvious; that, many times, we have a little card and we vote yes or no. We are present. And I think it is quite obvious how you would probably vote if you were voting on that measure at this point.

Thank you, Mr. Chairman.

Mr. GIBBONS. Mr. Pease.

Mr. PEASE. Mr. Chairman, I would like to thank the panel members for their testimony, and to indicate that this is a very complex area. We are being asked to deal with several dozen changes in the tax code, not all of which are 100 percent understood by all the members of the committee, and as a result we need all the help and guidance we can get.

You have indicated your willingness to be of help. If any one of you would like to accept the invitation, I would invite you to get a copy of this committee print and go through it page by page, and put your page on the front cover, and just write yes-no, yes-no, yes-no on each one of the provisions. I am serious about that. It would at least alert me, as one member of the committee, to those sections which need some looking at and those on which there is a broad consensus that changes are merited.

Mr. PILIERO. That is a very important issue, Mr. Pease, and we will take you up on it. There are many important changes which were lumped together with some that people might agree are sensible, with some that people might think are destructive of our economy, and we would like to bring that to the committee.

Mr. ELLENTUCK. The Tax Division has submitted pretty much what you are suggesting, to your staff, our positions, together with some explanatory material. I think that will be helpful.

[The following was subsequently received:]

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS,
Washington, D.C., February 29, 1984.

Mr. JOHN J. SALMON,
House Committee on Ways and Means,
Longworth House Office Building, Washington, D.C.

DEAR MR. SALMON: The American Institute of Certified Public Accountants (AICPA) appreciates the opportunity to offer preliminary comments on the proposed revisions to section 382 of the Internal Revenue Code (limitations on net operating loss carryovers).

Section 382(a) dealing with the taxable purchase of corporate stock and the concomitant survival of net operating losses, has been an enigma for the past 30 years. It is contrary to rational economic motivation. More importantly, it lacks predictability s to the survival of a net operating loss carryforward, and as a result, buyers have failed to compensate sellers for their net operating losses. This situation has been exacerbated by the 1976 Tax Reform Act. Amendments adopted in 1976, and repeatedly postponed until 1984, would effectively eliminate the net operating loss of a corporation when a controlling stock interest in a corporation is sold. The AICPA does not support the 1976 amendments, and we welcome the philosophy of the proposed bill as an alternative to the scheduled 1984 changes.

We believe that the proposed rejection of shareholder and business continuity as the measuring rod for the survival of net operating losses in taxable stock acquisitions is highly laudable. These standards were arbitrary, uneconomical, and defied predictability. Although we have some misgivings as to its application, the pool of capital theory, wherein losses will be offset against future income based on an invested rate of return, is a fairer, more objective and better conceptualized approach to loss survival in purchase transactions. While survival of losses in reorganization transactions is more objective under present section 382(b), there are legitimate loopholes and incongruities. Revised section 382(b) would effectively reduce losses pursuant to continuity of shareholder interest retained in a loss loss corporation. The effective loss reduction would not be pro rata but would be skewed adversely to small stock retentions.

The announced motivation for the revision to section 382 is simplicity, objectivity, and tax neutrality. As we understand these objectives, a "simple" proposal is one that is readily understood and easily applied by conscientious businessmen and their advisors; an "objective" proposal is one that does not require subjective determinations by taxing authorities; and a "neutral" proposal is one that produces substantially similar tax results for identical transactions, regardless of the form of those transactions. While we applaud these criteria, we have some concern as to whether they are being satisfied under the proposed legislation. A number of examples are illustrative of our point. We necessarily are limited in our comments due to the lack of available statutory language.

Proposed section 382(a) deals with sales and exchanges of a loss corporation's stock at the shareholder level. The stock purchase rules are inapplicable where 50 percent or less of the stock of a loss corporation changes hands, counting only 5 percent or more shareholders. The applicability of the section 382(b) merger rules would result in a statutory scale-down that is tied to the percentage of shareholder continuity maintained in the loss corporation. The merger rules are applicable if shares are isued to a new purchaser.

Under these rules, two essentially similar econimic transactions can give rise to wholly disparate tax results depending on the form of the transaction. Thus, assume individual B owns 100 percent of loss corporation L with a $5 million net operating loss carryforward. A sale by B of 50 percent of its stock to new investor, C, would trigger no scale-down or loss limitation under proposed section 382(a). However, if C obtains stock in L by purchasing unissued shares, only 35 percent of each year's income could offset the carryforward loss. This result does not promote simplicity or neutrality.

Assume the same loss corporation, L, wholly owned by B individual, is acquired solely for voting stock in a "B" reorganization. Target corporation shareholders receive 50 percent of the voting stock in the acquiring corporation. Since a "B" reorganization is under the purchase rule, more than 50 percent of L's stock must change hands or there is no scale down. If attribution is considered, L's shareholder still owns 50 percent of L through ownership of 50 percent of acquiring's stock and no limitation on losses applies. If attribution is not considered, a limitation based on a rate of return on the value of acquiring's stock received is applied. However, if L is acquired in a statutory merger for 50 percent of the voting stock, only 35 percent of pretax income may be offset each year by the loss carryforward.

We believe wide variations in tax consequences depending on the choice of reorganization form are inappropirate. This is particularly true when the "B" reorganization can be transmuted into what is essentially an "A" reorganization by a subsequent "separate" liquidation. Consider further that as new stock issues are treated under the merger rule, a conversion of a mutual savings and loan to a stock company results in complete elimination of any losses of the savings and loan. As no shareholders existed prior to conversion and there is no continuity after the conversion, this conclusion appears technically correct but inappropriate.

In addition to the shortcomings noted above, we question the soundness of the fundamental limitation of the proposal. At bottom, the proposal would impose an annual limit on the amount of income that could be offset by an NOL carryover. The stated theory of the annual limitation is that the new owners of a loss business should not be able to use a greater amount of carryover than would be available to the old owners if the latter had invested their assets in an income-generating activity. While this standard appears to be superficially fair, it should be noted that the model chosen for the old owners is a conservative investor who seeks a safe but unspectacular yield on this corporation's assets. In short, the model contains a fundamental bias against the successful entrepreneur who turns around a losing business overnight. Instead of rewarding such success, the proposal penalizes it by withholding carryovers that would have been immediately available in full to the old owners if they had the skill to turn around their business.

We also question the appropriateness of the scale-down, under the merger rule, from the percentage of stock owned by the loss corporation's shareholders to a lesser percentage of taxable income that can be offset by the loss corporation's carryover. The rationale for the scale-down appears to stem from a belief that part of the stock received by a loss corporation's shareholders is attributable to the carryovers acquired. It is one thing to argue for the existence of such a premium. It is another thing to place a value on this premium as the statutory table under the merger rule does. The statutory table is obviously slanted against big companies acquiring small companies, since the greater the disparity between the two corporations, the lesser the amount of income useable each year against a carryover. This same kind of bias is in present section 382(b) and has been criticized as being a notion more appropriate in anti-trust legislation than in tax legislation. In addition, the scale-down introduces complexity that is at odds with the Committee's goal of simplicity.

We are concerned with the lack of a graduated approach to the scale-down under the purchase rules. At a 50 percent sale of stock there is no net operating loss limitation. At 51 percent, a net operating loss is significantly "massaged" and the net operating loss that survives is made up of three components: (1) the purchase price of which the stock is sold multiplied by a return on an investment factor; (2) 49 percent (remaining shareholders' interest) multiplied by the net operating loss carryforward; and (3) built-in gains. Dramatic results transpire by a marginal cross-over of the 50 percent boundary. Such results may be beneficial to the taxpayer or may be beneficial to the Government. However, objectivity becomes difficult due to a number of factors which may make it difficult to determine whether or not the 50 percent border has been crossed. These factors include: (1) a evaluation determination when there is more than one class of stock; (2) the application of the attribution rules to determine the 5 percent shareholder and how much stock is sold by such shareholder; and (3) the necessity of making the computation between the loss and the carryover year which may be 15 years apart.

We are concerned that the aggregate effect of a number of limitations on the purchase price will effectively reduce each year's useable loss to a relatively insignificant number. Purchase price may be reduced by contributions to the capital of the loss corporation as well as cash or investment assets in each loss corporation. Purchase price, as we understand it, though discussions with the Joint Committee would also be reduced by the basis that the loss corporation had in its assets. In addition, a discount factor will be applied on a straight-line basis which will bring the utilization of the loss to a present value and finally the resulting figure is multiplied by an after-tax rate of return. The computation becomes far from simple and will not be readily understood by businessmen. Moreover, the resulting utilizable loss each year may be small and have no relationship to that generated in a turnaround situation.

Simplicity is also lost in reorganizations when stock and cash are paid. Since the cash portion of the transaction is treated under the purchase rules and the stock portion is treated under the merger rules, the resulting computation of the survival of net operating loss may be cumbersome at best.

Several additional points in the instant proposal require elaboration. With regard to the purchase rule, we assume that consideration paid will include liabilities of the loss corporation. A highly leveraged loss corporation will lead a buyer to pay less for its stock. However, the buyer will still be indirectly liable for these liabilities and must be given credit for paying them off in the determination of the total purchase price paid. We also understand that one element in the proposal is the repeal of section 269, with its subjective determinations of motive. We regard this as a positive step and suggest that it be made explicit.

We understand that there is a concern about the possibility of trafficking in built-in losses and that, to combat trafficking, Treasury would be directed to issue regulations limiting such losses. We regard this as a backwards step and one that is inconsistent with the Committee's stated goal of objectivity and the elimination of Section 269. It seems obvious that any such regulation would involve subjective determinations as to what constitutes "trafficking." We suggest that this special rule be reconsidered.

Finally, we will attempt to respond to the Committee's invitation for comments on the problems created under the proposal by a loss corporation which has coverted its operating assets to passive investment assets, i.e., the proverbial "cash cow". This problem and a related one, the "shell" corporation with no assets other than its net operating loss carryover, are ones that test the basic rationale of any section 382 proposal. The fact that these problems are particularly vexing for the instant proposal may say more about the merits of the proposal than the difficulty of the problems. For instance, neither the "cash cow" not the "shell" corporation presented much difficulty under the proposal advanced by the 1958 Advisory Group on Subchapter C, since that proposal insured that no buyer would pay for the carryovers of either kind of loss corporation. However, the instant proposal has difficulty with both kinds of loss corporations because in order to be effective, the instant proposal must have some sort of rules that operates directly on the permissible quality of assets in the loss corporation. We understand that the Committee has under consideration a rule that would not invoke any limitations on the loss corporation so long as its passive assets did not constitute "substantially all" of its total assets. The "substantially all" concept is a well established one in Subchapter C and we support its use in this context. We suggest that the term be defined in an objective way, as the IRS has done in Rev. Proc. 77-37. We recommend against any subjective definition, as has occurred in certain court decisions, e.g., *American Manufacturing,* 55 T.C. 204 (1970).

We understand that the instant proposal also has difficulty dealing with the situation where the seller artificially inflates the value of his loss corporation by "pumping up" his corporation through a temporary infusion of capital. This kind of "window dressing" is temporary because the buyer expects to withdraw such funds from the loss corporation after he buys it, thus reducing his effective purchase price. We understand that the instant proposal must have a special rule for this situation since, again, its basic mechanism does not operate directly on the loss corporation. While recognizing the necessity under the instant proposal to eliminate such "window dressing" from calculations of purchase price, we trust that others will recognize that any such special rules will be neither simple nor objective, thus creating another inconsistency with the Committee's stated goals.

In conclusion, we are in agreement with the approach taken by the proposed legislation and its rejection of the existing law and the 1976 approach. However, we believe that the dichotomy between the merger and purchase rules under the proposed legislation is unwarranted since it produces anomalous and formalistic results. While we endorse the pool of capital approach, we feel the effect of a number of limitations will whittle the loss down to a point that bears no relationship to economic reality and turn-around potential.

We urge that the moratorium on the 1976 approach be extended another year. This will enable Congress to have the opportunity to give due deliberation to the proposed NOL revisions and evaluate the suggested solutions to the problems and complexities inherent in the existing rules.

Sincerely,

Albert B. Ellentuck,
Chairman, Federal Tax Division.

American Institute of CPA's, Subchapter S Task Force

SUBCHAPTER S—RECOMMENDED TECHNICAL CORRECTIONS

(Prepared February 29, 1984)

A. Provisions contained in H.R. 4170

§ 1363 1. Eliminate constructive sale reporting under § 1363(d) for asset transfers in complete liquidations and reorganizations (including § 355 spin-offs). [§ 621(a)]

§ 108 2. Eliminate § 108(e)(6)(B) debt relief income to the extent the stockholder's basis in the corporation debt has been reduced for S corporation loss passthroughs. [§ 621(b)]. Should add reference to loss in old and new years.

§ 1367 3. Overrule the *Abdalla* case to apply S corporation loss pass-throughs prior to determination of the worthless stock loss or non-business bad debt for the shareholder's stock and loan investments. [§ 621(d)]

§ 1371 4. Charge accumulated earnings and profits for the recapture of investment credit claimed prior to the Subchapter S election deadline. [§ 621(e)]

§ 1361 5. Extend the grace period for election by the beneficiary of a qualified Subchapter S trust to conform to the Subchapter S election deadline. [§ 621(f)]. Should also conform to 2½ months period in § 1362(b)(1)(B).

§ 1362 6. Clarify the one day Subchapter C § 337 liquidation sale return filed an S corporation acquisition target where the acquirer elects § 338. [§ 621(g)]

§ 1362 7. Permit a Subchapter S election after the short taxable year-end to which the election relates, if the generral two and half month deadline rule is satisfied. [§ 621(1)]

§ 46(c)(8)(E) 8. Eliminate the shareholder level at-risk rule for recourse debt. [§ 431(a)]. Recommend expansion of proposed § 46(c)(8)(E)(ii) to recognize recourse debt owed to an equipment dealer or affiliate and revision of proposed § 46(c)(8)(E)(iii) to substitute active conduct of a trade or business and purchase of equipment at an arms-length price.

§ 46(c)(9) 9. Treat S corporation principal payments on non-qualified non-recourse debt as increasing the shareholder investment tax credit at-risk and vintage the investment credit earned to the year placed in service [§ 431(b)]. In addition proposed § 46(c)(9) should refer to reduction in nonqualified recourse debt.

§ 1362 10. Confine the § 1362(e)(3) consent to "close the books" after a Subchapter S election terminates, to shareholders during the S period and the first day of the C period [§ 621(h)]. Recommend that only shareholders during the S period be required for consent.

§ 318 11. Treat an S corporation as a partnership for indirect ownership attribution. [§ 621(c)].

§ 1362 12. Permit a new law Subchapter S election within 5 years after a revocation of an old law election [§ 621(k)].

§ 1378 13. Protect a fiscal permitted year for an S corporation year beginning in 1983 with a pre-10/20/82 Subchapter S election. [§ 621(m)].

§ 1379 14. Broaden reference to prior law to cover all taxable years. [§ 621(n)].

§ 465 15. Specify that a C corporation (not an S corporation) is subject to the § 465 at risk rule, when the corporation meets the § 542 stock ownership test. [§ 621(o)]

§ 1371 16. Specify that a PTTP cash distribution from AAA refers to § 1368(e) AAA. [§ 621(o)].

§ 6659 17. Eliminate the § 6659 overvaluation penalty at S corporation level. [§ 621(o)].

B. Provisions which would be desirable technical corrections, but which might be effectuated by interpretative regulations

§ 1361 1. Expand § 1361(c)(2)(A)(i) to include a trust holding stock for the shareholder's spouse or stock which constitutes community property.

§ 1361 2. Amend § 1361(d)(3) to treat a trust as eligible even though subject to partial reallocation in order to form a parallel trust for an after-born child or grandchild, provided all trusts for the class of beneficiaries qualify before and after the reallocation.

§ 1361 3. In the alternative specify in § 1361(d)(4) that a trust loses its eligibility by "cessation" when a reallocation occurs to accommodate an after-born member of the beneficiary class.

§ 1361 4. Expand § 1361(d) to treat a legal life estate as a qualified Subchapter S trust, at least for a life tenant with power of sale, who is treated as a fiduciary under Rev. Rul. 61-102, for consistent treatment with a usufruct interest.

§ 1362 5. Amend § 1362(d)(1)(B) to specify that a majority vote is required by each voting or non-voting class of common stock to approve a revocation of the Subchapter S election.

§ 1366 6. Expand § 662 to provide for the reporting by residuary beneficiaries, of a terminated estate or trust, of income or loss reportable under § 1366(a)(1) for an S corporation's year which ended after termination of the estate or trust.

§ 1367 7. Amend § 1367(b)(2)(B) to specify that the restoration of shareholder debt whose basis was reduced in old Subchapter S years is not restored by S corporation income for new law years.

§ 1367 8. Expand § 1367(a) to specify that all increases and decreases in stock and loan bases will be computed as of the end of the S corporation's taxable year.

§ 1368 9. Amend § 1368(e)(1)(A) to specify that the accumulated adjustments account cannot be reduced below zero.

§ 1368 10. Expand § 1368(a)(3) to permit designation of Subchapter C prior to Subchapter S accumulated earnings and profits.

§ 1368 11. Expand § 1368(c) to coordinate with § 1379(c) and specify that undistributed and previously taxed income distributions which satisfy old law § 1375 (f) and (d) are deemed to precede distributions from the accumulated adjustments account.

§ 1368 12. Expand § 1368(a) to specify that distributions of property in kind are measured by the fair market value of the property on the date of distribution.

§ 1368 13. Expand § 1368(e) to specify that all distributions are computed and characterized at the S corporation's taxable year-end and not at interim dividend dates, and to prorate mixed cash and property distributions.

§ 1371 14. Expand § 1371(a) to detail the transactions for which Subchapter C, rather than Subchapter K controls, viz. all of Subchapter C Part I, except for current earnings and profits precluded by § 1371(c) and dividend property basis rules; Part II, except § 332; Part III, § 381 except to the extent precluded by § 1371(b); and § 385 except as controlled by the § 1361(c)(5) safe harbor straight debt rules.

§ 1372 15. Expand § 1372(a) to specify whether a non-deductible shareholder-employee fringe benefit actually paid should be considered a § 1367(a)(2)(D) non-deductible expense, or a § 1368 distribution to the shareholder benefitted.

§ 267(f) 16. Expand § 267(f) to provide a de minimis rule, viz. a minimum percentage of ownership commonality for related entities.

§ 62(1) 17. Amend § 62 to add § 162 interest expense paid by an active S corporation shareholder on indebtedness incurred or continued to acquire or carry stock of or loans to an S corporation.

§ 613A 18. Amend § 613A(c)(8) to specify that an S corporation is not a member of a controlled group of corporations or a business entity under common control with a related C corporation.

C. Additional technical corrections which do not appear feasible by interpretative regulations

§ 55(e) § 163(d) 1. In the alternative to B. 16. amend § 55(e)(3) and § 163(d) to allow an interest deduction on indebtedness incurred or continued to acquire or carry stock in or loans to an S corporation.

§ 613A 2. In the alternative to B. 17 amend § 613A(c)(8)(B) to treat related C and S corporations as businesses under common control so that conversion from or to S corporation status will not constitute a disqualifying transfer of proven property for § 613A(c)(9) and allocate the depletable oil quantity among the corporations.

§ 1362 3. Amend § 1362(e)(3) and § 1377(a)(2) to confine the shareholder consents to persons who were stockholders during the S period, or prior to the termination of the shareholders interest respectively.

§ 1362 4. Expand § 1362(e) to provide authority to the Internal Revenue Service to grant an extension of time to file the Subchapter S election and a QSST beneficiary election.

§ 1363 5. Expand § 1363(d) to provide exceptions to gain recognition where the appreciated property transfer qualifies under the § 311(d)(2) exceptions.

§ 1363 6. Expand § 1371(a) to exempt an S corporation from § 291, i.e. confine to C corporation.

§ 1375 7. Amend § 1375(b)(1)(A) to exclude § 103 interest income from taxable excess net passive income.

§ 1378 8. Expand § 1378(c)(3)(A)(ii)(III) to include a buy-sell agreement with another family, also owning stock in the old law corporation on September 28, 1982.

§ 1379 9. Consideration should be given an expansion of § 1379 to specify all integration details between the old law and the new law.

§ 1368 10. Consideration should be given to solving the tax pitfall on non-taxable income, including the § 1367(a)(1)(C) percentage depletion addback, combined with accumulated (Subchapter C and Subchapter S) earnings and profits. The solution could follow the § 705 partnership interest approach by adjusting the § 1378(e) accumulated adjustments account for non-taxable income and non-deductible expenses.

Mr. Pease. One more question, Mr. Chairman.

Could the members of the panel comment on Senator Moynihan's suggestion made this morning in his testimony regarding the minimum tax and an exclusion of paper losses from inability to escape the minimum tax?

Mr. Fein. Mr. Pease, I think the definition of paper losses, whether use of the term "paper losses" is something that is a very easy word to use, it is a very difficult concept to draft, to understand.

Certainly, there are losses in real businesses that take the form of partnerships, that take the form of subchapter S corporations, et cetera, which should be treated as much of a loss as an expense, as if it was an itemized deduction or a contribution or another business expense.

There are other losses that this committee and the Congress may decide are not so intended; that they do not view that the loss has the same significance.

We applaud the approach of trying to deal with some of the problems in a way, possibly of using the minimum tax as a method of imposing a flat tax overlaying the entire tax system. I think we are coming very close to that.

I think that could be a very useful manner of targeting the types of issues where you say this is a viable social program, social need; however, we are not going to let the taxpayers use too much of a good thing. So that's how the alternative minimum tax can be fine-tuned.

I think just saying all paper losses, all tax shelters as such, should be thrown out and be used as an item of tax preference is inappropriate, but I think it is a general approach that deserves further consideration and study.

Mr. Piliero. There is one other comment on that. That is, the distinction people try to draw between earned income and unearned income. I think one of the witnesses pointed to it, but it is very important not to lose sight of the fact that the country was made great by people who were willing to borrow or offset their earned income with real risk-taking.

Very often we say that an investor who is offsetting a loss against earned income somehow or another is doing a bad thing. That is a good thing, and the committee ought not to be prejudicial against people who are using their earned income and taking real risks.

Mr. Berenson. As I understood the Senator's comments, he was talking about those areas of tax shelters which could also encompass tax-favored incentives supported by this committee, but I think he was only directing his views towards those that lack economic substance.

So there would have to be a clear distinction. "Shelter" has gotten to be an all encompassing bad word—as to those areas that are bona fide incentives, as intended by Congress, and those type of shelters that are unintended or abusive. I guess it is only the latter that the Senator would really direct his proposal because otherwise the alternative minimum tax, with its disallowance of deductions such as State and city income, property, and sales taxes—and you have many industrialized States which have suffered greatly in this past recession, with high property taxes, high income taxes, high sales taxes, which would be disallowed to a broad range of executives if you are not very careful.

As a practical matter when substantial State and local taxes become a 100-percent cost due to their nondeductibility, decisions on relocation and job impacts have resulted. You could have significant dislocation on the State level. Also State and local municipal bond interest costs will adjust upward as a result of broadening the flat rate 20-percent alternative minimum tax.

Mr. Pease. Thank you very much.

Mr. Gibbons. Other questions of the panel?

[No response.]

Mr. Gibbons. I think Mr. Pease has made an excellent suggestion. If you do one for Pease, do one for Gibbons. I would appreciate it.

Thank you very much.

OK, the next panel, the American Bar Association, Mr. Delaney; Mr. Martin Ginsburg of Georgetown University Law Center; Mr. Aidinoff of the Securities Industry; and Heather Ruth of the Public Securities Association.

Mr. Aidinoff, I will apologize for having massacred your name there.

Let's start with Mr. Delaney. Go right ahead.

STATEMENT OF EDWARD N. DELANEY, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION, ACCOMPANIED BY JOHN B. JONES, JR., CHAIRMAN, GOVERNMENT RELATIONS

Mr. Delaney. Mr. Pease, I might just start by saying we have commented on some 45 items in the two writeups. You will find those in our written submission.

We are going to summarize, very quickly, our position on some general concepts rather than on specifics.

Let me say first, I am Edward N. Delaney. I appear today in my capacity as chairman of the Section of Taxation of the American Bar Association, and I am accompanied by Mr. Jones, our vice chairman on Government relations.

The views I express today are those of the tax section, and not those of the ABA, except as noted in our written statement.

I must point out as a first statement that the present pattern for developing tax legislation makes it extremely difficult for the tax section to present its views. Over the years, this section has, I think, earned a reputation presenting informed views of those who practice tax law as to how well legislative proposals will carry out the substantive intent of the proposers.

We try not to suggest to Congress how tax burdens should be borne or shifted; rather, our focus is whether a new provision reaches those whom it is intended to affect and no others, without unnecessarily complicating the tax law or placing too great a burden on either the taxpayer or the Internal Revenue Service.

In carrying out this task, both in regard to developing our own legislative proposals and in evaluating those of others we have found it is necessary at an early stage to study the legislative proposals in the context of fully developed statutory language. Only through the discipline of drafting can anyone fully appreciate the ramifications of making a significant change in the Internal Revenue Code.

Obviously, most of the proposals pending before this committee have not reached that stage, and our comments are, therefore, incomplete.

Mr. GIBBONS. Let me interrupt. I think you are right and I regret that we have to make tax policy the way we do here. But we seem to be falling deeper and deeper into the hole every year, and it gets worse rather than better.

Mr. DELANEY. We understand that, Mr. Chairman, but we nevertheless feel we have got to continually make that point to see if we can't get the time for a really thoughtful consideration of the drafting of the language.

I would like to express the profound hope that, despite the political and procedural problems involved in tax legislation, a way will be found so that especially informed groups of citizens can make their views known with respect to the laws that will govern them and those they advise.

In view of the limited time for preparation which has been available, our written statement covers only the administration's tax shelter, accounting, and corporate tax reform proposals.

In an addendum, I include some preliminary comments on the possible proposals included by the Joint Committee staff statement of February 17. These include a number of significant changes in the tax laws. For the most part, at least from the descriptions presently available, they are aimed at alleged abuses of the tax systems. Some of the proposals cut too broad a swath or place too heavy an administrative burden on legitimate transactions.

Such provisions should be sharply limited or transferred to a more deliberate legislative process.

I will comment on only a few of the matters covered in our written statement, and hope that you will look at the full written statement.

Accounting reforms, the time value of money, and economic performance proposals deserve careful study. They have been designed to deal with perceived abuses in the tax accounting area involving mismatching of income and expense. The time value of money proposals seek to revise the methods of identifying the portion of deferred payments that represent interest, to prevent what is perceived to be a premature deduction of expenses claimed before the taxable period to which they are properly allocable, and to prevent what is perceived as a premature tax accrual of major expenses that need not be paid until years later.

We would welcome the opportunity to testify on these reform proposals after they have been more fully developed, preferably after they have been translated into proposed statutory language. At that time, we and other professional groups would be better able to consider the competing problems of tax equity and complexity, and to make alternative proposals and suggestions for finetuning.

One concern noted by several practitioners is that the proposals are not even-handed. They are all designed to increase tax revenue by preventing the taxpayer from enjoying the time value of deferred payments.

There are other situations to which the present accounting rules work unfairly against taxpayers. If the Congress legislates regarding the premature expense payments and accruals, it should also deal appropriately with premature income receipts and accrual.

We are very concerned about the very short basis on which——

Mr. **Gibbons.** What page, Mr. Delaney? Is this in your formal testimony, so I can follow you here at the same time?

Mr. **Delaney.** Yes, it is.

Mr. **Gibbons.** Can you tell me what page you're on?

Mr. **Delaney.** Yes. I was talking, beginning at page 18 and moving on to page 19, 20, and 21.

I would also like to refer you to our comments on premature accruals on page 28. We are very concerned that the tax system cannot command respect if the only principle is to accelerate income and postpone deduction. There must be a rationale consistency.

If there is to be a change from the all-events test in accrual accoulting, it should be applied consistently. The economic performance test, so far as it has been articulated to date, does not meet that standard.

I would like to point out that in the corporate area, a good deal of study is required and should be given to a much broader concern. Nevertheless, on dividend distributions of appreciated property, what is commonly referred to as one aspect of the general utilities case, there is a consensus in the tax section that that problem should be resolved by legislation, and that appreciated property should result in taxation at the corporate level.

Thank you.

Mr. **Gibbons.** Thank you, Mr. Delaney.

[The prepared statement follows:]

STATEMENT OF EDWARD N. DELANEY, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

I am Edward N. Delaney, Chairman of the Section of Taxation of the American Bar Association. The views I express today are those of the Section of Taxation and its members and, except where expressly noted, not those of the American Bar Association which has not considered these matters.

I must point out at the outset that the present pattern for development of tax legislation makes it extremely difficult for the Section of Taxation to present its views. Over the years the Section of Taxation has, I submit, earned a reputation for presenting informed views of those who practice tax law as to how well legislative proposals will carry out the substantive intent of the proposers. We try not to suggest to Congress how tax burdens should be borne or shifted; rather, our focus is whether a new provision reaches those whom it is intended to affect and no others without unnecessarily complicating the tax law or placing too great a burden on either the taxpayer or the Internal Revenue Service.

In carrying out this task, both in regard to developing our own legislative proposals and in evaluating those of others, we have found that it is necessary at an early stage to study legislative proposals in the context of fully developed statutory language. Only through the discipline of drafting can anyone fully appreciate the ramifications of making a significant change in the Internal Revenue Code. Obviously, most of the proposals pending before this Committee have not reached that stage and our comments are, therefore, incomplete.

The Administration's proposals are set forth in its budget proposals and in a Summary prepared by the staff of the Joint Committee dated February 3, 1984. It has been barely possible to communicate effectively with the dozen or so Tax Section committees knowledgeable about the numerous fundamental changes involved in time to clear my statement with the Council of the Section and appear before you today.

On Friday, February 17, 1984, the Joint Committee staff issued a 108-page pamphlet presenting a number of new proposals, some of which are far-reaching. Interested parties could hardly be expected to testify on these matters, since the time to request an appearance before the Committee expired the next business day. To say that there has been a hearing on these new proposals would be a travesty on the legislative process. I am not able to address them in any detail and urge that new hearings be scheduled.

I would like to express the profound hope that, dedpite the political and procedural problems involved in tax legislation, a way will be found so that an especially informed group of citizens can make their views know with respect to the laws which will govern them and those whom they advise.

In view of the limited time for preparation which has been available, I shall present our views only on the Administration's tax shelter, accounting, and corporation tax reform proposals designeated as III.A.4. in the Joint Committee Summary of February 3, 1984, and discussed at pages 22 through 42 of that document.[1] This inlcudes a large number of significant changes in the tax laws. For the most part, at least from the descriptions presently available, they are aimed at alleged abuses of the tax system. Some of the proposals cut too broad a swath or place too heavy an administrative burden on legitimate transactions. Such provsions should be sharply limited or transferred to a more deliberate legislative process.

a. Tax Shelter Provisions

I. PARTNERSHIP ALLOCATIONS

1. Partnership allocations and distributions

(a) Under this proposal if a direct payment by a partnership for property or services would be chargeable to capital, allocations and distributions of partnership income would be treated in the same manner as payments to a third party. Also, other "abusive' partnership allocation and distribution "schemes" would be prevented.

If this proposal is limited to gross income allocations and distributions to general partners for services which if paid to a third party would have to be capitalized, it appears to be a useful and worthwhile change in the law.

However, this proposal may extend also to allocations of gross income to general partners for services which if paid to a third party would not be capitalized. An inference can be drawn from the description that if the dollar amount of the allocation would constitute "unreasonble" compensation under section 162 standards, the gross income allocation would be disregarded. For instance, if an individual general partner of a limited partnership which owns and operates an apartment complex is allocated 20% of annual gross receipts of the complex in excess of a 70% occupancy level as an incentive to maximize its profitability and the dollar amount thereof in a particular year exceeds the salary or other compensation which the partnership would be required to pay a non-partner employee or independent contractor for the same service, this proposal possibly could be interpreted to disallow a portion of that allocation. Nevertheless because such a general partner bears a substantial risk of loss if the complex is not profitable, there may be valid business reasons to compensate him at a higher level than a non-partner employee or independent contractor.

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[1] In an addendum starting at p. A-1, I include some preliminary comments on the "Possible Proposals" incuded in the Joint Committee Staff pamphlet of February 17, 1984.

The statutory language should thus exclude any possible inference that "unreasonable" compensation concepts may be applied and the proposal should merely prevent gross income allocations for services which would not be currently deductible if paid to third parties because those services result in an asset having a useful life which extends beyond the year of payment.

It appears that any allocation of income to a property contributing partner up to the amount of the fair market value of the property contributed would be deemed a nondeductible guaranteed payment by the partnership to him which would have to be capitalized as the partnership's acquisition costs of the property. This result effectively prevents property contributing persons from becoming true partners but treats any contribution of property to a partnership as a sale of that property. Such a result does not comport with the classical partnership model whereby one partner contributes property and the other services to a partnership in order to share future profits from the enterprise. If the profits allocated to the property partner must be treated as the purchase price of the property, the typical partnership structure is absolutely destroyed.

There appears to be no valid policy reason why the allocation of income to a property contributing partner should be treated as the purchase price of the property so contributed, although there may be some policy reasons why allocations of income to service partners should be so capitalized. The revenue effect of this proposal appears to be minimal, particularly in light of the fact that the proposal would retain a rule regarding simultaneous contribution-distribution arrangements which woud cover virtually all types of purported contributions and distributions which in fact are sales. It is unnecessary to go beyond the simultaneous contribution-distribution proposal from a policy viewpoint and if the proposal should do this it would jeopardize any valid partnership arrangement pursuant to which one partner contributes property and the other services to join in a bona fide business enterprise to jointly share the profits therefrom.

(b) Under another part of this proposal when a partner contributes cash or other assets and another partner is distributed that cash or other asset, the transaction will be treaded as a sale by the distributee of a portion of his partnership interest or a portion of any property he contributes to the partnership simultaneously therewith, provided the two transactions are related.

The rules of section 721 and 731 dealing with contributions and distributions of assets afford a desirable level of flexibility in allowing partners to opt to either preserve a carryover basis for contributed assets or to acquire a stepped-up or stepped-down basis for those assets, depending upon the negotiations between themselves.

This proposal would greatly limit that flexibility without a corresponding curtailment of any abusive tax shelter techniques. The property contributing partfer in most of the transactions to which this proposal is directed is a geleral partner who contributes improved or unimproved land to the partnership. Thus, the tax shelter investors do not benefit by any increase in the basis of those assets so as to obtain greater depreciation deductions and a lesser amount of gain or sale. Conversely, under this proposal while the contributing partner will recognize an immediate capital gain (taxed at effective rates not in excess of 20 percent), much higher depreciation and cost depletion deductions as well as reduced gains on sale will result for the tax shelter investors. Thus, this proposal will probably result in a net revenue loss particularly in light of the fact that many contributing general partners have substantial net operating losses which could be used to offset their recognized gains on these transactions.

In the event the pending proposal is adopted, however, the following provisions should be contained in it:

(1) Cash or property distributions to property contributing partners which are funded other than by cash or property contributions of other partners should be automatically excluded from the application of this rule. Where the distribution is made substantially simultaneously with the funding of loans to the partnership, the cash distribution should be presumed to have been funded with the proceeds of those loans and, thus, should be excluded from application of this rule.

(2) Cash or property distributions made more than two (2) years following the contribution of cash or the distributed property should be excluded from application of the rule so as to reduce the number of subjective determinations necessary for its application.

(3) Cash or property distributions to the extent made to maintain the capital account balances of the partners in the same proportion as their interests in residual partnership profits or losses should be excluded from application of this rule be-

cause such distributions are not in exchange for partnership interests but, rather, made to maintain capital in the same ratio as residual profits or losses are shared. Such distributions are not disguised asset or partnership interest sales and should not be converted into them under this proposal.

2. Partnership retroactive allocations

This proposal eliminates use of an "interim closing of the books" method of allocation for purposes of section 706(c)(2)(B) and apparently relegates the partnership to a daily proration method of allocating income and deductions, similar to the method contained in Reg. § 1.706-1(c)(2)(ii) with respect to sales of the seller's entire interest in the partnership under section 706(c)(2)(A). The proposal would also require income, gain, loss, deduction and credit of a subsidiary partnership to be allocated equally among the days in a partnership's taxable year for which it has an interest in the subsidiary to determine the allocable shares of income, gains, losses, deductions and credits of the partners of the parent partnership.

(1) Interim closing

(a) Although the stated purpose of this proposal is to prevent newly admitted partners of a cash method partlership from being allocated deductions which accrued during a particular year prior to the date of their admission but which were paid by the partnership after their admission, e.g., interest, it can easily be circumvented by deferring payment until the first day of the following partnership year. The new partner would thus be able to deduct his full distributive share of the payment in that year.

(b) The proposal would apparently continue to allow the interim closing of the books method for purposes of sales of an entire partnership interests under Reg. § 1.706-1(c)(2)(ii) and section 706(c)(2)(A). The interim closing of books methods should be retained for this purpose because it has long been viewed by Reg. § 1.706-1(c)(2)(ii) as the more exact or precise method of allocation and as the preferred method.

(c) There seems to be no legitimate policy reason why if it is the more exact method for purposes of sales of entire partnership interests it should not be so treated for purposes of admissions of partners into partnerships. The interim closing of the books method for cash method partnerships affords a very useful business tool in negotiations between existing partners and new partners who would infuse needed capital into the partnership for legitimate business purposes. If that capital is used to actually pay such accrued expenses, provided the allocation of those expenses has "substantial economic effect" under section 704(b), the allocation should be recognized.

(d) If, however, this proposal is adopted, the following provisions should be included:

(i) The proration should be based only on the number of days over which the income and deductions would have been accrued if the partnership were an accrual method partnership. Thus, if a partnership is formed on January 1, 1985, it incurs an indebtedness on July 1, 1985 and interest thereon then commences to accrue, a new partner is admitted into the partnership on October 1, 1985 and all accrued interest thereon is paid on December 31, 1985, the new partner should be allocated one-half of his distributive share of the partnership's interest deduction.

(ii) The interim closing of the books method should continue to be permitted provided the effect thereof is not to allocate to a newly admitted partner a share of the deduction greater than his distributive share of the portion thereof which accrues after the date of his admission. Thus, in the example set forth in paragraph (d)(i) above, if the interest rate provided on that debt is a floating rate tied to a published prime rate and adjusted daily, monthly or quarterly, the partnership's interest expense attributable to the third quarter of 1985 may be significantly larger or smaller than its interest expense for the last quarter of 1985. The newly admitted partner should be able to be allocated his distributive share of interest attributable solely to the fourth quarter through an interim closing of the books method of allocation.

(2) Tiered partnerships

The tiered partnership proposal appears to be valid and desirable provided (a) interim closings of the subsidiary partnerships' books would continue to be a permitted method of allocating the subsidiary's income or loss among the members of the parent partnership and (b) interim closings of the subsidiary's books could be made whenever a partner was admitted into the parent partnership. The Service in Rev. Ruls. 77-310 and 78-2 looked through the parent partnership and treated both partnerships as one for purposes of retroactive allocations and optional basis adjustments, respectively. Thus, if the interim closing of the books method is preserved generally, it should be available to subsidiary partnerships as well in allocating their income or loss to parent partnership and the partners thereof, provided the parent partnership also utilizes an interim closing.

3. Contributions of property to partnerships

(a) This proposal makes mandatory the provisions of section 704(c)(2) dealing with contributions of property to a partnership.

This provision is substantially identical to the American Law Institute ("ALI") proposal which was approved by the entire Section of Taxation in July, 1983. However, the ALI proposal was limited to marketable bonds and securities. Nevertheless, many members of the Committee on Partnerships believed this proposal should have been extended to contributions of all types of partnership assets and it would appear that most members of that committee would approve such an extension.

(b) This proposal also requires that built-in losses on contributed capital assets would retain their character for five years. Property which is inventory in the hands of the contributor would retain its character as ordinary income property for five years in the hands of the partnership as would unrealized receivables.

This proposal may be necessary to prevent certain perceived abuses although some members commenting do not believe the practice is widespread and believe this proposal unnecessarily complicates the law.

4. Application of section 751(a) to distributions of partnership interests by corporations

Under this proposal when a corporation distributes a partnership interest to its shareholders it will recognize as ordinary income the same amount of ordinary income it would have recognized, apparently under section 751(a), if it had sold the interests for its fair market value.

This proposal is desirable so as to make the tax effects of distributions of partnership interests identical to those which result from the distribution of assets in kind.

However, as proposed it would cause ordinary income to be recognized on the distribution of "substantially appreciated inventory items" as well as on the distribution of "unrealized receivables." Because a distribution by a corporation of inventory does not generally trigger gain recognition to the corporation, the distribution of an interest in a partnership owning such inventory should not cause the partnership to recognize ordinary income.

Thus, the proposal should not simply apply section 751(a) based on the fair market value of the partnership interest as if it were sold, but should limit the application of section 751(a) here only to the extent ordinary income would be generated if the corporation owned and distributed undivided interests in the partnership's assets equal to its shares of those assets.

II. LIKE-KIND EXCHANGES

This heading involves two unrelated proposals. The first deals with exchanges of partnership interests. The second tackles the broad area of deferred exchange, a problem with which the Section of Taxation has been wrestling for several years.

Exchanges of partnership interests.—We agree with the Administration that for many people partnership interests are quite like stock or other securities which may not be exchanged tax free. The partnership interests which involve more active participation are not likely to be the subject of an exchange of any kind. Since the exchange of a partnership interest can be used as a tool to escape recapture at the end of a tax shelter, the Administration proposes elimination of tax-free treatment for interests in different partnerships. While this proposal is simplifying, it is contrary to the full fragmentation proposal of the ALI Subchapter K project which was approved by the ABA Tax Section in July 1983. However, until a full fragmentation approach is adopted it would appear appropriate to make taxable all exchanges of partnership interests.

Deferred exchanges.—The decision of the Ninth Circuit in *Starker* which allowed a five-year delay in completing a tax-free exchange has occasioned thought and comment among our members. We are currently considering a legislative recommendation which would approve that result in many cases. Some members suggest that no legislation is needed as the Treasury has adequate power to deal with abuse situations by Regulation under section 453(f)(6)(C) as amended by section 303 of P.L. 97-448.

What is really needed is a comprehensive standardization of tax-free exchanges generally, a project for which we have a special task force which has met informally with your staff, the staff of the Joint Committee, and the staff of the Senate Finance Committee. Since there is no current tax shelter abuse, we urge that the Administration's *Starker* proposals be held for more deliberate consideration.

In any event, the 90-day period seems much shorter than necessary and could interfere with legitimate exchanges hung up on mere procedrual technicalities.

III. CHARITABLE CONTRIBUTIONS

We agree with the Administration that a major feature of some tax shelters has been an unrealistic valuation of a charitable contribution. The present over-valuation penalty does not solve the Internal Revenue Service's enforcement burden in reaching these shelters. We think the proposal to limit a donor's deduction to cost unless the property has been held for more than three years (one year in the case of a marketable security) is a reasonable and effective correction. Translating this general principle into legislative language may involve substantial further problems. For example, in the case of inherited property, and heir might wish to give inherited property to charity as soon as he gets it. In such a case, the heir should be least have a deduction for estate tax value of the property.

Another proposal would remove the over-valuation penalty exemption for property held more than five years. In view of the wide subjective valuations possible where the property has been held for a long time, we would require a stronger showing than has as yet been made public to overturn the original legislative judgment made only two years ago.

We express no views on the increase of the percentage limitation from 50 percent to 60 percent, or lengthening of the carryover period from five years to fifteen years.

IV. MARKET DISCOUNT

The Administration's proposal here seeks to eliminate that part of capital gain on bond disposition which is attributable to accrued market discount. While the principle of the Administration's proposal is indisputable, it is necessary to see draft legislation before commenting. To the extent that instruments are sold by relatively unsophisticated investors, it may be difficult to effect compliance.

b. Accounting Reforms

The Administration's "time value of money" proposals deserve careful study. They have been designed to deal with perceived abuses in the tax accounting area, involving mismatching of income and expense. In paticular, the Administration has proposals to revise the method of identifying the portion of deferred payments that represent interest, to prevent what is perceived as the premature deduction of expenses paid before the taxable period to which they are properly allocable, and to prevent what is perceived as the premature tax accrual of major expenses that need not be paid until years later.

The Section of Taxation has recently established a special Task Force on the Time Value of Money. That Task Force has been charged with the responsibility of evaluating the problems in this area and with assisting the Section in developing recommendations for this and other Congressional tax bodies. We expect to share the results of our work with this and other such bodies as they consider the Administration's proposals.

It would be useful to have more specific data on the areas of abuse and the extent of their utilization. It is easy to see that these are perceived abuses, but more information might lead to better targeted reforms.

There are no rules in all taxation which affect the day-to-day operation of business as much as the tax accounting rules. Every corner grocery store has to have, or employ someone who has, a working knowledge of tax accounting. Any significant change which is made, especially with little notice, in the tax accounting rules is likely to arouse substantial resentment. If the rules are badly thought out or perceived as being unfair, the resentment will be even greater. It is possible that this touches the area in which enforcing compliance would be the most difficult if the taxpaying community systematically adopted a posture of evasion, as is the case in many foreign countries.

We would also welcome the opportunity to testify on these reform proposals after they have been more fully developed, preferably after they have been translated into proposed statutory language. At that time, we and other professional groups would be better able to consider the competing problems of tax equity and complexity and to make alternative proposals and suggestions for fine tuning.

One concern note by several private practitioners is that the proposals are not even-handed. They are all designed to increase tax revenues by preventing taxpayers from enjoying the time value of deferred tax payments. There are other situations in which the present tax accounting rules work unfairly against the taxpayer. If the Congress legislates regarding premature expense payments and accruals, it should also deal appropriately with premature income receipts and accruals.

Practitioners have also noted that the Administration's proposal regarding deferred payments is conceptually inconsistent with its proposals regarding what is regards as premature expense deductions. In the deferred payment area timing of the receipt is respected, but in the expense area timing of the payment or accrual is challenged. More study might produce a more consistent set of solutions.

The perceived tax abuses that are the target of the proposals may merit the proposed solutions, but before Congress takes action here, it should thoroughly consider all of the ramifications of each proposed change. Quick changes in this area could result in unintended consequences. For example, we now see how section 483, which was added to the Code to correct a tax abuse, is now the source of one of the present tax abuses. In particular, each proposal should be carefully tested from the standpoints of complexity, ease of compliance, and ease of administrability.

The Section of Taxation will be happy to cooperate in that activity.

III. INTEREST-FREE LOANS

For the past three years, the Tax Section has had a Task Force studying the problem of interest free loans. Its work has not been conclused and its recommendations have not been submitted to the Section for adoption. It concluded that legislation is desirable both as to income and gift tax issues. Now that the Supreme Court has decided the gift tax issue in *Dickman*, legislation is desirable to deal with the methodology of imputing interest, the rates to be charged, exemptions to the rules and the income shifting potential of such loans.

The Task Force's basic approach is similar to that of the Administration's proposal in dividing interest free loans into two transactions. This approach imputes a payment to the borrower from the lender which may be a gift or compensation. In addition, an interest payment is then imputed from the borrower to the lender. The major areas of disagreement between the approaches of the Task Force and the Administration concern the treatment of term loans and the approach to a de minimis exception. The Task Force believes that undue complexity should be avoided, if possible.

Under the Administration's proposal, term loans would be divided into a discounted note bearing a fair rate of interest and a payment of something else. Something else is a gift, compensation, or a dividend. In the case of an employer/employee term loan, an employer would receive a compensation deduction in year 1 equal to the difference between the amount of the loan and the discounted note value, and the employee would have a like amount of compensation income. In future years as interest accrued on the note under rules similar to the original issue discount rules of Section 1232A, the employee would be deemed to make interest payments and the employer would have interest income. This approach leads to artificial deductions to the employer and income to the employee.

The Task Force determined to treat all interest free loans whether demand or term as demand loans for the following reasons:

(1) Simplicity;

(2) Differing tax consequences would place a premium on planning;

(3) Allowing parties to gain more favorable tax treatment by structuring a demand loan would lead to sub rosa agreements further undermining our voluntary system of taxation.

De minimis exclusion

Both the Administration and the Task Force proposals provide for exclusion from the unstated interest rules. The Task Force would allow an exclusion of $10,000 of unstated interest for each loan from a lender to a child of the lender and $10,000 of unstated interest with respect to loans from a lender to all other individuals, including parents of the lender. For purposes of these rules, a husband and wife would be considered a single lender. By contrast, the Administration proposes to exclude loans of up to $100,000 received by each borrower. However, the Administration would not exempt the unstated interest from such loans to the extent that the borrower has more than a de minimis amount of passive investment income. We understand that the prime motivation for the Administration's approach is the fear that the Task Force's approach would allow the shifting of enormous amounts of income from high to low bracket taxpayers.

Neither the Task Force nor the Administration proposal favors or hurts all taxpayers. For example, the Administration proposal would permit more excluded loans from a grandparent to numerous grandchildren and fewer loans to a single grandchild with four wealthy grandparents. However, numerous loans to a single recipient lowers income shifting potential as the borrower is pushed into higher tax brackets. Further, the income tax abuse is the shifting of the lender's income. Thus, theoretically it seems more correct to limit the lender's exclusion. The Task Force further believes that testing the exclusion at the lender level will facilitate administration and compliance.

Under the Administration's proposal, in order for the lender to know whether the amount is exempt, it is necessary to know the other loans that are made to the same borrower. Thus, if the borrower does not inform the lender concerning these loans, the lender may believe in good faith that there are no other loans and that no income need be imputed. Under the Task Force's method of computation, the exemption is based upon looking at both the lender and borrower; thus, if a grandparent is loaning to more than one beneficiary, the grandparent will know that the loan does not qualify for an exemption and an imputation of income is required. It is true that under the Task Force's proposal, if the grandparent is loaning to several grandchildren, the grandchildren will not know whether or not the loan is within the exemption unless the grandparent tells the grandchild. This, however, would have the effect only of the grandchild not taking a deduction for the imputed interest paid. Thus, there would be an incentive on the grandparent's part to disclose this information to the grandchild; and, if this is not done, it will have a beneficial effect upon the revenue, not disadvantageous effect upon revenue.

We believe an exemption based on the amount of the loan is less desirable than one based on the amount of the imputed interest in the case of loans with an interest rate below the specified rate.

The Administration's proposal denies the exemption to the extent of passive income in excess of a minimum amount on the borrower's return. This has the disadvantage of requiring the return of the lender to be dependent upon the information on the return of the borrower. We are cognizant of the concerns with respect to income splitting but are also concerned at the intrusiveness required. Perhaps this kind of intrusiveness is not too much of a practical problem when dealing with minors. It may result in substantial problems, however, when the situation is a child supporting an elderly parent. The parent may be quite reluctant to disclose sources of passive income to the child. This also may be true of loans from parents to adult children, such as for funds for a down payment on a house or other purposes. We would hope that such limitations would not be viewed as essential and would be willing to work with Staff to develop what possibilities there are for alternatives.

One alternative might be to deny the exemption in the case of loans to minors.

If the problem is viewed as one of concern that financial institutions will encourage such activities through loans to parents who re-loan the funds to the children, the legislative history could have discussion of the problem of bona fides of the loan, and with adequate reference to *Creel* v. *Commissioner,* 72 TC 1173, aff'd sub nom *Martin* v. *Commissioner,* 649 F.2d 1133 (5th Cir. 1981), which should be adequate to prevent this type of activity. We believe that case law and publicity should be sufficient and that it would not be necessary to have an amendment to section 265 to deal with questions of borrowings for the purpose of making interest free loans.

We believe the concept of passive income leads to considerable complexity including the problem of definition. For example, would it include tax-exempt interest? How would various exclusions or deductions to exempt certain interest or dividends be handled? Would amoufts reinvested in public utility stock be considered passive income? Would investment in appreciating securities, discount bonds, deferred annuities or houses be considered to be passive income?

Many practitioners feel that the enactment of the Task Force's de minimis rule would not open the flood gates of income shifting, beyond their present limits.

(1) Taxpayers can shift income by means of a *Clifford* trust.

(2) They can shift income by making transfers under the Uniform Gift to Minors Act. In addition to the numerous devices which are currently properly and improperly being used to shift income, it must also be realized that many taxpayers are not willing to make loans to their children which could be dissipated or reached by judgment creditors of the child.

(3) The parent often wants the income from the investment rather than giving it to the child. Our task force stands ready to work with the Staffs of the tax writing committees on this exemption.

IV. RELATED PARTY TRANSACTIONS

The proposal under this section is to broaden the scope of Code § 267 to include partners, partnerships and controlled corporations, and at the same time provide for matching the income and deduction of the related parties rather than complete disallowance. The Section of Taxation has had a chance to consider statutory language directed at the same ends embodied in H.R. 4170. It is not clear that the impact of this provision in consolidated return situations has been thought through. Other than that, we support these changes as reasonable and simplifying.

V. LIFO CONFORMITY

The Section of Taxation and the ABA favor the elimination of the conformity requirement. Until that change is made, we agree with the Administration that the LIFO conformity rules should not be avoidable simply because the inventory is held by a subsidiary. If the final statutory language is limited to that goal and does not, for example, require uniformity of inventory methods among subsidiaries, we would not oppose this change.

VI. PREMATURE ACCRUALS

We are greatly concerned that the taxpaying public will view these proposals as one-sided. The Service and the courts have already discarded financial accounting rules by placing many cash-basis taxpayers who must pay in advance on the accrual method for tax purposes, and accrual-method taxpayers who receive advance payments on the cash method for tax purposes. These proposals further bias the system in favor of the Treasury by disallowing or discounting accrual-method deductions when payment will not occur until later, while ignoring the similar disparity when payment occurs before accrual, and refusing to discount income accrued before it is received.

The tax system cannot command respect if the only operative principle is to accelerate income and postpone deduction. There must be a rational consistency. If there is to be a change from the "all events" test, it should be applied consistently. The "economic performance" test so far as it has been articulated does not meet that standard.

VII. ESTIMATED TAXES

H.R. 4170 contains important provisions for eliminating the cliff effect of penalties for under-payment of estimated tax, as well as a provision requiring estimated tax payments for the alternative minimum tax. The Section of Taxation testified in favor of both revisions in hearings on H.R. 3475. It is not clear from the Joint Committee pamphlet whether the Administration's proposal embraces both aspects of H.R. 4170, but it should. We support the changes in estimated income tax included in H.R. 4170.

VIII. STRADDLES AND OTHER SECURITIES TRANSACTIONS

The Section of Taxation takes no position on that portion of the Administration's proposals which deals with straddles and other securities transactions.

C. Corporate Tax Reforms

I. DIVIDENDS

1. Leveraged stock investments by corporations

Under § 265(2) no deduction is allowed for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from the income tax. This proposal will extend this provision so as to apply to debt incurred or continued by a corporation to purchase or carry dividend producing investments where the dividends are subject to the dividends received deduction of § 243.

Certain aspects of the proposal need to be clarified. As we understand the proposal, interest paid will be associated with dividends received under a "but for" test. As described in Treasury's General Explanations, this test would apparently require a direct tracing of interest to the deductible dividend. We favor a direct tracing rule as an equitable device and, despite its facts and circumstances nature, as easier to administer than are the rules announced in the revenue procedures implementing § 265(2).

With respect to the amount of interest to be disallowed, we would favor a rule which would limit the amount of the disallowance to an amount not in excess of the dividends received deduction allowable with respect to the debt financed investment. The tracing rules applicable to exotic dividend pay-out schedules or unusual interest payment schedules or original issue or market discount investments, should be left to Treasury Regulations and should not be addressed in the statute.

We note that the proposal would not apply in cases where the leveraged stock represents an interest in a corporation in which the taxpayer holds an 80 percent or greater interest. In general, this will exempt dividends eligible for the 100 percent dividend received deduction under section 243(a). This is good policy to the extent it helps to assure that corporate earnings are taxed only twice—once while in corporate solution and once when distributed to taxable shareholders. Further, it may be that dividends received by a small business investment company operating under the Small Business Investment Act of 1958 should also be excluded from this proposal.

This new provision should not become effective until a date after the date of enactment. Considerations of fairness and equity require some notice period before taxpayers are presumed to know the details of a new tax law. In addition, appropriate transitional rules should apply to in-progress transactions, although present investments should also eventually be brought under the new rule.

2. Expenses incurred in connection with short sale transactions

This proposal, which partially reinstates (after over 60 years), the rule that "in lieu of dividends" are capital expenditures to the short seller, is not objectionable. In the case of extraordinary dividends, however, if the investor is truly at risk with his investment, it is unclear why still another holding period requirement is needed. We recommend that the one year rule be dropped in lieu of the 16 day period rule of present law.

We agree that "in lieu of dividends" which are not required to be capitalized under this rule should be treated as interest for purposes of the investment interest limitation, and for purposes of limitation on deduction of interest allocable to tax exempt income.

3. Receipt of extraordinary dividends by corporations

Under the proposal as described in the Treasury's General Explanations, the term extraordinary dividend would be defined to include all dividends paid in any 90 day period which equal or exceed 5% of the taxpayer's basis in preferred shares or 10% of the taxpayer's basis in common shares. But in any event, a dividend would be considered extraordinary if total dividends paid within a one year period exceed 20% of the shareholder's basis in the shares. It is unclear whether a shareholder's basis in his shares, for purposes of applying the objective test will be determined on a share-by-share and block-by-block basis, or whether the taxpayer will be allowed to set dividends received against his entire stock basis in determining the extraordinary character of a distribution. Clearly, a direct tracing concept must also be applied here.[2] Thus, the character as extraordinary or not should be determined on a share by share or block by block basis. If a dividend is determined to be extraordinary with respect to some stock (and if that stock is not held for more than one year) its basis should be reduced even though other stock of the same taxpayer in the distributing corporation is not affected.

In defining the term "extraordinary dividend" the administration's proposal relies on the percentage test described above. No explanation of the reasons why these particular percentages were chosen has been provided. Perhaps, a more practical and less theoretical definition of what constitutes an extraordinary dividend would involve a three year look back rule. For example, if a particular stock paid a dividend equal to an average of 10% of average fair market value every year for the previous three years, a 10% dividend in the fourth year could hardly be viewed as a return of capital. In the alternative, if the present tests are adopted, provision should be made for Treasury review and exemption of particular dividends from extraordinary dividend status on a case by case basis.

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[2] For example, the receipt of a dividend on low basis stock held for more than one year should not result in an extraordinary dividend which can affect the basis of stock held for less than one year.

We note with approval that, in general, the amount of the basis reduction will equal the amount of the extraordinary dividend not subject to tax. It is unclear how this basis reduction rule would affect the interest deduction disallowance rule proposed under 1. above. If an interest deduction is denied with respect to a dividend that dividend would, in effect, be taxed twice if it also resulted in a reduced basis in the stock. Therefore, it would appear that the basis reduction rule should not apply to dividends the receipt of which resulted in a lost interest deduction.

Under the Administration's proposal, the amount of any property distribution would be the fair market value of the property distributed for purposes of determining the amount of any basis reduction. This is true even though the amount of the distribution for dividend purposes, and the corporate shareholder's basis in the property, would be the basis of the property distributed in the case of appreciated property. This creates the possibility of the same gain being taxed twice, once in the form of reduced stock basis and again on the sale of the distributed property. Therefore, the amount of the distribution for basis reduction purposes should equal the amount of the distribution for dividend purposes.

The holding period suspension rules should, of course, be the same for purposes of this proposal and § 246. (relating to rules applying to deductions for dividends received) In this connection, a "functional analysis" with respect to at risk status would be useful if properly explicated. However, care must be taken to assure that suspension occurs only during such times as the taxpayer is truly not at risk with respect to an investment. For example, it would be inappropriate to suspend holding period if an investor has granted a just-in-the-money covered call (as opposed to a deep-in-the-money covered call).[3]

With respect to the one year rule, we question whether the 16 and 91 day rules of present § 246 do not represent sufficient periods for a taxpayer to be truly at risk with respect to an investment, especially if the rules with respect to at risk reduction are expanded and given a "functional analysis," before the investment will be deemed to have economic substance independent of the tax laws.

We note that this proposal applies to dividends received from an 80 percent or more subsidiary whereas the proposed leveraged stock investment rule does not. We do not believe that investments in 80 percent or more affiliated corporations represent instances where the "abuse" at which this proposal is directed can occur. Further, we think that application of this proposal in such a case can result in the inhibition of sound business judgment. In any event, affiliated corporations filing on a consolidated basis should be exempt from this basis reduction rule.

Finally, we note that this proposal entails a rule functionally unrelated to the basis reduction rule. This part of the proposal would provide that in the case of a corporate distributee, the holding period for property received as a dividend distribution could not exceed the distributee's holding period for the shares of the distributing corporation. We do not oppose this rule. If adopted, this proposal should allow the taxpayer to attribute the average holding period of his stock with respect to which the distribution is made, to the distributed property. In this way undue complications, with respect to split holding periods for example, could be avoided. Further, a de minimus rule should apply. For example, if 5 percent or less of the recipient's stock has a holding period of less than the corporation's holding period for the property distributed, this holding period variance would be ignored.

4. Dividend distributions of appreciated property

This proposal deals with a part of the so-called *"General Utilities"* controversy. The proposal would tax a distributing corporation on its distribution of appreciated property to non-corporate shareholders as a dividend distribution as if the corporation had sold the property for its fair maket value on the distribution date.

In our consideration of the broader proposals for the reform and simplication of the corporate tax now being considered, a consensus has developed that there is little or no justification for the provisions of present law exempting corporations from gain on ordinary dividend distributions of appreciated property. Thus, we support this change, though it might better be done as part of the overall review of corporate taxation.

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[3] We understand that in-the-money and deep-in-the-money are defined terms under legislation which may be introduced this year in the Senate. The definitions described in that proposal appear to be workable for most taxpayers.

5. Transfers of partnership interest by corporations

This proposal raises questions of partial or full "fragmentation" of partnerhip interests for § 336 and §§ 337/338 purposes. We agree that partial fragmentation (i.e., separate treatment of § 751 assets) is desirable in the §§ 337/338 and § 336 settings. We think, however, that it should be clearly stated in the committee reports accompanying the enactment of such a provision that no inference should be drawn with respect to partial or full fragmentation in other areas. For example, no inference should be drawn with respect to the issue of whether or not partial fragmentation should apply with respect to the application of § 1239 and § 453 to the sale of partnership interests in certain situations.

In addition, we note that the policy of partial fragmentation is inconsistent with the policy contained in TEFRA § 247, which was intended to encourage liquidation of professional corporations. However, apparently due to the press of time in which § 247 was drafted, the provision as passed by the Congress in 1982 does not accomplish its policy objective. The technical deficiencies in § 247 should be corrected. Further, the proposed treatment for distributions of partnership interests should not apply to distributions by professional corporations.

The effective date should be delayed, or appropriate transitional rules drafted.

II. INVESTMENT COMPANIES AND MUTUAL FUNDS

1. Accumulated earnings tax

While we do not oppose this proposal, we do not understand that it would be necessary to have a statutory amendments to cause the accumulated earnings tax to apply to widely held corporations. There does not appear to be any statute, regulations, or other fixed rule of law that restricts application of the accumulated earnings tax to closely held corporations.

We cannot comment on the "auxiliary changes" proposed to be made in the manner of computing the accumulated earnings credit and earnings and profits until these are published. We hope we will then have an opportunity to comment in a timely fashion. This underscores the importance of treating all the proposed corporate tax changes in a single proposal.

The effective date of this proposal should be delayed beyond the date of enactment to provide time for taxpayers to learn of and accommodate themselves to the new rules.

2. Capital gain dividends from mutual funds

The policy of preventing taxpayers from converting short term capital gain to long term capital gain through the use of RICs or REITs, unless they have a true economic investment in the entity for a minimum period of time, has already been established in § 852(b)(4). The minimum period presently prescribed is thirty-one days, whereas that proposed is six months. Why an increase is warranted, or if one is warranted, why six months is the correct period, is to us nuclear.

III. COLLAPSIBLE CORPORATION REVISIONS

Tax Section opinion on this provision is divided. Some feel the substitution of a two-thirds test for the substantially all rule is a useful proposal. Such a rule more closely comports with the policy underlying the collapsible corporation provisions and should help simplify compliance as well as administration of the law. Others feel that hasty tinkering with one of the most complex and draconian code sections will produce unintended results. They note that a possible goal of the Subchapter C studies now going on is complete elimination or major revision of the collapsible corporation provision.

If the provision is adopted, some conforming amendment needs to be made to the "70/30" rule of § 341(d)(2). We have certain concrete recommendations on this matter and would appreciate the opportunity to convey them to the tax writing committees of Congress at their convenience.

In line with the Section's long standing policy to oppose retroactive tax legislation, we view the retroactive effective date as undesirable.

IV. TRANSACTIONS INVOLVING FOREIGN CORPORATIONS

The Administration has made two proposals dealing with the U.S. taxation of a foreign transaction: (1) the taxation of transfers of certain assets to foreign corporations, and (2) a proposal with respect to controlled foreign corporations. In addition, the pamphlet published by the Joint Committee on Taxation discusses several other proposals in the foreign area. All these proposals are important and far reaching in effect. We were unable to prepare detailed comments on these proposals in the short time allowed us.

One of our Committees raises some questions about the section 367(a) proposals: If the proposed standard for tax-free transfers to foreign corporations—whether a transfer has the effect of avoidance of Federal income taxes—is not intended to tax all transfers, it is meaningless without guidance on how effect is measured. Is effect measured immediately, over the life of the asset transferred, or over the life of the business; does payment of foreign income taxes constitute avoidance of U.S. income taxes; does qualification for non-taxation under Subpart F constitute avoiding U.S. income taxes; does potential taxation under Subpart F indicate lack of avoidance? Without guidance on these questions, taxpayers could not proceed without advance rulings.

The proposal to eliminate tax-free transfers of intangibles is a policy choice further limiting deferral, precludes U.S. persons from participating in joint ventures requiring contributions of intangibles, and may reasonably be expected to encourage either foreign based research and development or cost-sharing agreements so that the resulting intangibles are foreign owned. Intangibles are usually paid for by royalties because they are hard to value. foreign countries are not likely to allow deduction for higher royalties than presently paid. The result is likely to be double tax. The proposal would be less objectionable if it were limited to technology-type transfers.

Foreign branch losses, which are not part of an overall foreign loss, presently reduce the numerator of the Section 904 foreign tax credit limiting fractions and, thereby reduce allowable foreign tax credits. If foreign branch losses are to be recaptured at the time of transfer there is, in effect, a double penalty for the use of branch losses.

Addendum

In addition to the administration's proposals, the document prepared by the staff of the Joint Committee on Taxation and first released on February 17, 1984, contains a number of "Possible Proposal." Many of these "Possible Proposals" have not previously been examined and some have wide implications. It would be most undesirable for these to become law without adequate time for comment.

We offer the following preliminary comments on some of them:

EXTENSION OF AT-RISK RULES TO REAL ESTATE LIMITED PARTNERSHIPS (P. 34)

This has been previously considered and rejected. Such a change would be a dramatic change from existing law and should occur only after careful consideration of the use of nonrecourse debt in real estate transactions other than tax shelters. Distinguishing between publicly traded partnerships and others may benefit those of higher income. Publicly traded partnerships usually involved lesser investments than privately placed transactions.

MULTIPLE TRUSTS (P. 35)

The tax benefits of multiple trust may be greatly exaggerated. Tust are taxed at higher brackets than single individuals and a penalty is imposed on accumulation distributions from more than two trusts. Attempting to combine trusts will lead to increased controversy and will likely be avoidable by the careful practitioner. Costs of administering trusts (including preparation of tax returns) limits the use of multiple trusts. Decisions would have to be made concerning the effect of such legislation on existing trusts. If applied to existing trusts, taxpayers may attempt to claim the benefits of combining trust to avoid the penalty on accumulation distribution from over two trusts. This proposal should be carefully examined to make sure it is not a revenue loser.

DISTRIBUTIONS OF APPRECIATED PROPERTY BY TRUSTS OR ESTATES (P. 36)

The statutory language of this proposal should be given wide exposure to see if there are administrative problems and which of the two alternatives of gain recognition or carryover basis is best.

TAX BENEFIT ITEM (P. 76)

Statutory language concerning this proposal is most important to determine that a taxpayer is only being taxed on a recovery for which a deduction or exclusion was received.

PREMATURE EMPLOYER CONTRIBUTION TO BENEFIT PLANS (P. 86)

This proposal has broad application. Whereas abuses in this area should be stopped, at times VEBAs are used merely to obtain a tax deduction for an expense accrued according to GAAP but denied under the strict tax rules.

"GOLDEN PARACHUTE" COMPENSATION ARRANGEMENT (P. 104)

This proposal reverses long established law that an employer receives a deduction and an employee receives income when cash is paid. The present rule is a good neutral principle of tax policy. This change cannot be based on tax policy, but seems intended to discourage these arrangements. It thus is an attempt to intervene on one side of tender offer contests. It is doubtful that it can be drafted in a way that will not include many other situations.

NONDISCRIMINATION RULES (P. 107)

We agree that a uniform definition of non-discrimination applicable to all fringe benefits is desirable. The present use of many different tests of non-discrimination all through the employee benefits area makes both voluntary compliance and enforcement unnecessarily difficult. The development of a uniform definition might be a major simplifying and welcome step. We will be glad to work with the Committee, but our experience suggests that it takes a lot of time and care to resolve difficulties between well-established Code tests.

LIMITATION ON DEPRECIATION AND INVESTMENT TAX CREDIT FOR EXPENSIVE AUTOMOBILES (P. 104)

It is unclear whether this proposal is intended as tax policy or trade policy. The provision should deal with questions of how depreciation recapture is to be allocated and like-kind exchanges of existing cars and cars subject to the provisions treated.

Corporate Matters

1. TRANSACTIONS IN STOCK WARRANTS (P. 52)

The American Bar Association reaffirms its support for its Legislative Recommendation No. 1983-3. Under this proposal, the treatment to an issuing corporation of the lapse or reacquisition of a warrant to acquire its stock would be clarified. In general, under the Recommendation, warrant expirations and reacquisitions at a gain would be treated as nonshareholder contributions to the capital of the issuing corporation triggering the appropriate basis adjustment rules of present law. As nonshareholder capital contributions, such expiration and reacquisition transactions would not directly result in income to the issuing corporation. Rather, income would result indirectly through the reduction of corporate property basis. The contributions to capital would be treated as occurring on the expiration or repurchase date. The Recommendation would also make clear that the provision in the Code dealing with sale of options (§ 1234) does not apply to warrant expiration or reacquisition transactions.

The Recommendation deals only with the treatment of income. We would like to supplement our submission with comments on the proper treatment of losses realized on the expiration or reacquisition of warrants.

2. BROTHER-SISTER CONTROLLED GROUP OF CORPORATIONS (P. 51)

We question the wisdom of the proposal to repeal the 80% test of present § 1563. In our view, the 80% test was intended to assure that, before two or more corporations could be treated as a single corporation for purposes of the surtax exemption, each of these corporations must be closely held. The 50% test performs the additional function of guaranteeing that ownership of each of these corporations is substantially identical. Both requirements are still useful in determining whether or not two corporations represent an attempt to disguise a single business.

The second proposal mentioned in this area is, apparently, to conform the definitions of affiliated groups for § 1563 and § 1504 purposes. Subject to further study after the proposal has been further explicated, we would support an amendment to the definition of "affiliated group" for § 1504 purposes which would conform, with appropriate adjustments, the ownership requirements for that purpose to those applicable under § 1563 with respect to multiple surtax exemptions.

3. NONTAXABLE ORDINARY DISTRIBUTIONS (P. 53)

While we understand that this proposal is not technically a part of the corporate reform package now being considered by the Senate Finance Committee, the role of earnings and profits in the determination of the ordinary income consequences of ordinary corporate distributions is a subject that should be considered in the broader context of such proposed corporate tax reforms and simplifications.

4. DISTRIBUTION OF DEBT BY A CORPORATION (P. 54)

We concur that the appropriate adjustment to earnings and profits upon a corporation's distribution of its own debt obligation is the amount that the recipient shareholder includes in income as a consequence of that distribution. Further, subject to added study in the context of the accounting proposals, we consider it appropriate to apply the OID rules to such obligations on the theory that the amount of income included by the recipient shareholder establishes the obligation's issue price.

We would view any proposal to establish a special rule for treating debt as equity for this purpose as counterproductive to any organized attempt to rationalize the debt/equity area.

However, we reiterate the fact that this issue would best be resolved in the context of an overall approach to corporate tax issues.

5. TAXES OF SHAREHOLDER PAID BY CORPORATION (P. 57)

The proposal to repeal § 164(e) appears to us to represent sound tax policy. Taxes should be deductible by those upon whom imposed, and payment by a corporation of the liabilities of its shareholders is logically a dividend. The policy problems of this provision have been compounded by *Hillsboro National Bank* v. *Commissioner*, 457 U.S. 1103 (1983).

6. REDEMPTIONS THROUGH THE USE OF RELATED CORPORATIONS: CORPORATE SHAREHOLDERS (P. 56)

This proposal represents an important retreat from the concepts reflected in the dividends paid deduction that, in general, corporate earnings should only be taxed once while in corporate solution.

Sections 304 and 302 serve to distinguish dividends from stock sales. If a shareholder's interest in a corporation is undiluted by a purported stock sale, then a distribution made with respect to that purported sale is taxed as a dividend. Separately, the Congress has provided a dividend received deduction to serve the policy that, in general, corporate earnings are taxed only once while in corporate solution.

This proposal would tax what is a dividend as if it were not. The effect is either to ignore the substance of the transaction or to reduce the effect of the dividend received deduction. We do not view either as a good tax policy.

While the proposal has not been raised in connection with the corporate reform package now being considered by the Finance Committee, we view it as the type of proposal which should be considered in that broader context.

7. DISTRIBUTIONS IN LIQUIDATION (P. 57)

This proposal would expand the classes of assets that result in recognition of income to a corporation making a distribution in liquidation. Some change is desirable. However, this is another effort to deal with the *General Utilities* issue, which is best addressed in the broader context of corporate tax reform and simplification.

8. MULTIPLE-CLASS GRANTOR TRUST (P. 55)

This proposal would preclude arrangements under which corporate grantors are allocated dividend income from trust-owned stock, while individual grantors are allocated all appreciation in value of the stock. We question whether this kind of activity warrants a legislative proposal and consider it appropriate that the subject be given additional study.

9. INSIDE BASIS ADJUSTMENT ON THE ACQUISITION OF A CORPORATION IN AN INVOLUNTARY CONVERSION (P. 58)

We oppose this proposal because it would result in the double taxation of the same gain: once by way of the reduction in the cost basis of the stock acquired, and once again by way of the reduction of the inside basis of property to the corporation. Further, this proposal seems inconsistent with the growing trend of treating a corporation as a separate taxable entity from its shareholders.

10. DIVIDENDS RECEIVED DEDUCTION COMPLIANCE (P. 41)

This proposal, which is to expand the dividend reporting provisions to require the reporting of "in lieu of" dividends, is not objectionable.

Mr. GIBBONS. Our next witness is Mr. Ginsburg.

STATEMENT OF MARTIN D. GINSBURG, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER, WASHINGTON, D.C.

Mr. GINSBURG. Thank you, Mr. Chairman.

My name is Martin D. Ginsburg. I am a professor of law at Georgetown University Law Center. Once upon a time, I practiced tax law.

The administration's general explanations of today's proposals sound, in the main, a common theme, a consistent reference to new planning developments, new schemes, each different in technique, but nearly all alined in a common objective of jobbing the system.

Legislation is needed, not to stay ahead of America's gloriously ingenious tax bar, but merely to stay within hailing distance. Congress is being invited to run the Red Queen's race. Sadly, I do not see how Congress can refuse the invitation.

As I have tried to detail in the written statement, I support the administration's proposals with one general reservation—some of them do not go far enough or straight enough to be effective—and one specific exception.

I would turn first to that exception, in part, because I have an apology to make before the clock runs.

The administration's ill-starred proposal relates to so-called Starker transactions. On simultaneous exchanges of like-kind property held for business or investment, under section 1031, which has been the law about half a century, no gain or loss is recognized. In this and in every other area of the tax law in which the issue has arisen, with amazing consistency the courts have held and, indeed, the Internal Revenue Service, 27 years ago, publicly ruled, that nonrecognition is the result, whether an exchange is simultaneous or it is not simultaneous.

The Treasury now proposes to require recognition of gain or loss if—but only if—more than 90 days intervene between the day I transfer black acre to you and the day I receive from you white acre in exchange. The administration's general explanation catalogs a series of perceived tax problems that relate, for example, to burned-out tax shelters, but the administration's proposal does not solve those problems because, in fact, they are not there to be solved.

The reason, simply, is that you already solved them. You did it in section 303 of the Technical Corrections Act of 1982.

About that legislation, in my written statement I treated the Treasury unfairly. I had thought, and said, that Treasury initiated the 1982 legislative change, and in now requesting a different change demonstrates a lack of institutional memory. The congressional staff informs me that, although Treasury was apprised of and did not object to the 1982 Technical Correction, Treasury did not initiate it. My assertion of inconsistency and memory lapse on Treasury's part thus was unfair, and I regret it.

It remains, however, that Congress on its own already has solved the catalog of problems of potential abuse. If the newly proposed amendment to section 1031 is to be enacted nonetheless, it is interesting to consider on whom the axe will fall.

Let me suggest who it will be. Mr. A lives in Chicago and owns a small apartment building, his only asset of value. He is about to retire to Florida. He would like to exchange his rental apartment building in Chicago for one in Florida. His problem is that he does not yet know the right building to acquire in Florida, and a mistake would be ruinous. He is the perfect candidate for a nonsimultaneous exchange.

When he leaves Chicago, Mr. A transfers the apartment building to unrelated B Corporation which wants it. He gets to Florida and searches for a building. He spends some time observing the market, and finally notifies B that he has found the right building. It is acquired. And ultimately, Mr. A receives it in what is a nonsimultaneous exchange.

Now, that may take 100 days or 120 days or 240 days. Mr. A cannot set that timetable in advance. The Treasury proposes to tax Mr. A who, under current law, is not taxed, and it proposes to tax him when he receives the building in Florida. That is, it proposes to tax him when he receives the like-kind property and no cash, at the very time it has become clear he does not have the money with which to pay the tax.

That will be the impact of enacting this piece of legislation.

Now, if to no discernable purpose, you reverse 50 years of consistent tax law in this way, Mr. Chairman, I think they will stone you in the streets.

As pointed out in my written testimony——

Mr. GIBBONS. They are already trying that in Puerto Rico right now. [Laughter.]

Mr. GINSBURG. Well, in any event, as I pointed in my written testimony, there really is a meritorious technical amendment to section 1031 it would make sense to adopt, because it would appropriately distinguish the case in which the taxpayer has the contractual right or the election to receive cash from one in which all he is going to get is like-kind property and no cash.

I think that would be a sensible clarification of present law. Any more intrusive change is both unneeded and, given the target of it, rather unfair.

If I could have approximately 60 seconds——

Mr. GIBBONS. Go right ahead.

Mr. GINSBURG. Thank you very much, Mr. Chairman.

In that remaining minute, let me briefly focus a couple of the larger issues involving substantial revenue to which the administration's proposals, it seems to me, do not adequately attend.

The omitted abuses are borrowing against installment obligations, cash in hand but tax-deferred 10 or 15 years, and, more pervasively, the mismatching of net yields to the buyer and the seller whenever property is sold for long-term installment obligations.

The buyer's basis includes the debt, and thus the depreciation stream is large from day one, while, deferring tax a decade or more, the seller earns interest on the entire principal sum, not merely on the after-tax portion. In practical effect, throughout the term of the installment obligation, the Government is making a no-interest loan to the seller, equal to the tax-deferred.

Nicely designed, and my colleagues who surround me here would design it nicely, the arrangement allows the seller to accumulate net interest on the Government's share equal to the deferred tax liability when it is finally paid. In the real world, the seller does not pay the tax to the Government; the Government pays the tax to the Government.

Now, that does not make any sense, and it never did.

Finally, the administration's proposal, once again to tinker with the accumulated earnings tax, reflects a similar misfocus. The Treasury is right that the penalty tax largely is ineffective, but this proposal is polishing the bridge work when the ship is sinking.

The essential problem is not all that complicated. If Corporation X unreasonably accumulates income in 1974 and, after unending procrastination and the waging of total law, loses the case in 1984, it then must pay the long-deferred tax. But, under current law, Corporation X is charged not one penny in interest to compensate the fisc for the 10-year delay. If Congress is minded to fix the accumulated earnings tax, that is the place to fix it.

Thank you, Mr. Chairman.

Mr. GIBBONS. Thank you, Mr. Ginsburg.

[The prepared statement follows:]

STATEMENT OF MARTIN D. GINSBURG, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER, WASHINGTON, D.C.

Mr. Chairman and Members of the Committee: My name is Martin D. Ginsburg. I am a professor of law at Georgetown University Law Center where I teach various subjects in the field of federal taxation. Over the past fifteen or so years it has been my privilege to testify before this Committee on a number of occasions, at times at your request, more often simply out of an interest in the subject, but never on behalf of a client. I appear today as an academic but I trust not a disinterested witness.

My approach to today's proposals is not entirely academic. For some twenty years before becoming a law school teacher, I practiced law in New York City, most of those as the partner in charge of the Tax Department of one of our dozen or so largest law firms, and while in practice I had the privilege of chairing both the Tax Section of the New York State Bar Association and the Committee on Taxation of the Association of the Bar of the City of New York, from all of which I obtained a keen appreciation of the gigantic ingenuity of the tax bar and the wonderfully inventive schemes those folk produce year after year.

That experience colors my approach to the proposals at hand. With a specific exception or two, I appear today to support the Administration's package.

I wish it could be otherwise. The nation is drowning in tax legislation. Few if any can keep up with much of it. But some out there are able to keep ahead of important segments of it and that is why we are here this morning.

The Administration's general explanation of February 17, 1984, makes the point. It is riddled with references to new developments, new schemes, each different in technique but nearly all aligned in a common objective of jobbing the system. The medical profession distinguishes necessary surgery and elective surgery. So ought we. We should go slow, in the tax field, before inflicting elective surgery on the weakened body of the Internal Revenue Code. But necessary surgery is another matter and necessary surgery, in the main, is what the Administration proposes.

Most of the proposals seem to me sensible as outlined. Technical problems of course there will be, as of course there will be some remaining after even the most careful legislative process, our tax law having reached that irreducible level of complexity. One can only hope that after a Bill is presented, the bar and accounting groups will be afforded sufficient opportunity to furnish detailed comment to the excellent staffs of this Committee and of the Joint Committee.

General proposals, I think, are best addressed in an equivalently general way. I would like to do that in two parts. First, some suggestions to make more effective a few proposals that seem to me welcome and well directed but inadequately reactive to the abuses they seek to address. Second, a strong but I hope reasonable condemnation of a specific Administration proposal, one I find amazingly wrong-headed, coupled with a suggestion of the quite different, tailored legislative change the Administration ought to have requested, if indeed any change in the statute is necessary at all.

I. Suggestions of Further Support

A. TIMS: PLEDGING INSTALLMENT OBLIGATIONS

The Administration closes its TIMs proposal with this non-proposal: "The legislation would not amend the installment reporting tax rules with respect to pledges of mortgages that are installment obligations to collateralize loans, and no inference as to the current tax treatment of such pledges is to be drawn." This reticence seems to me comprehensive only if the Administration contemplates corrective legislation to deal generally with the pledging of long-term installment obligations. The level of tax abuse is substantial, in both volume and concept, and it is proliferating. The current tax treatment of these transactions, as to which no inference is to be drawn, is astonishingly hospitable to tax avoidance.

The case is easily made. Assume Mr. A owns stock of X Corporation, value $10 million and basis $1 million. Unrelated B Corporation wishes to purchase. If Mr. A sells for cash, he must pay long-term capital gain tax of $1,800,000. Preferring to defer tax payment but wishing cash in hand, Mr. A sells his X stock for a $10 million negotiable promissory note of B Corporation, bearing interest at the market rate and maturing 15 years hence, secured by a standby letter of credit issued by the largest bank in America. Automatically entitded tm installment reporting, Mr. A accrues no current tax liability. Looking to keep it that way but seeking cash to expend in riotous living, Mr. A borrows $9,500,000 from his own bank and pledges the B note as security. He intends to maintain the loan a full 15 years and will pay interest at approximately the same market rate that B pays interest to him.

I think it rather clear under current law that, properly structured, the arrangement triggers no early recognition of Mr. A's postponed gain. It is a senseless result. The installment method, as this Committee well understood in promoting the excellent Installment Sales Revision Act of 1980, is designed to coordinate receipt of cash and liability to tax. It is not intended as a tax shelter, cash today and tax 15 years hence.

If Mr. A had borrowed $9,500,000 from his bank pledging the X stock, and then had sold to B subject to the debt, the installment reporting rules this Committee confirmed in 1980 would treat that nonbusiness borrowing as a payment and impose on Mr. A immediate capital gain tax liability of $1,710,000. If builder Z were to sell homes encumbered by construction indebtedness, the installment sale rules, more generous when qualifying business indebtedness is in the picture, would treat as taxable gain only the amount, if any, by which the indebtedness exceeds the builder's rather substantial basis in the property sold.

The same rules ought to apply when Mr. A and builder Z elect to borrow against installment obligations post-sale: Mr. A to live well, builder Z to repay its construction indebtedness. The same firm treatment of Mr. A; the same more generous, but not toothless, treatment of builder Z.

B. DEFERRED PAYMENT SALES: YIELD ON THE GOVERNMENT'S MONEY

The Administration focuses on interest mismeasurements and certain buyer-seller tax discontinuities that arise in deferred payment transactions. The concerns expressed are serious and the solutions proposed meritorious. But omitted from the Administration's catalogue is a problem as great or greater than any listed. It arises in the context of installment sales and, realistically, it swallows up the pledging issue addressed above.

Mr. A owns valuable real property, land and building, worth a total $10 million (land $2 million and building $8 million). His aggregate adjusted basis in the property is $2 million and, of the $8 million appreciation, $3 million is subject to depreciation recapture. Unrelated B Corporation wishes to purchase the property and is willing to pay either $10 million in cash or to issue a well secured negotiable promissory note maturing 10 years hence, prinicipal amount $10 milion, bearing interest at a full market rate. Either way, B looks forward to depreciating its new $8 million basis in the building as quickly as the law allows. If Mr. A accepts cash, he must promptly pay tax of $2,500,000 and will retain $7,500,000 to invest, let us assume, at a full market rate of interest. If Mr. A accepts B's note, tax on his gain will be deferred ten years and he will annually receive interest on $10 million. Not surprisingly, Mr. A opts for the installment sale.

Let us assume the market rate of interest is 12%. On the $2,500,000 of tax that Mr. A has deferred ten years, he annually will receive interest of $300,000. Each year he will pay the Government $150,000 tax on that interest income and he will retain the balance of $150,000. Assuming annual reinvestment and compounding, at the end of 10 years Mr. A will have accumulated, after tax, nearly $2 million. Every penny of it is attributable to Mr. A having had for ten years the investment benefit of deferred tax liability.

There are various ways to describe this state of affairs, none very complicated. One is to recognize that Mr. A has been allowed to invest the Government's money for his own account. Another equates the tax deferral to a loan from the Government, reminds us (as the Supreme Court told us last week) that the tax law does not appreciate no-interest loans, and would impose on the taxpayer an appropriate interest charge. A third approach would simply recognize that we do not, but we should, tax the privilege of deferral.

Our failure to do so skews the system. B Corporation, the purchaser, is awarded a full $10 million basis, and thus the benefits of full depreciation, from the outset. Mr. A does not pay tax on his $10 million sale until the cash is in hand ten years hence, which is well and good, but from inception he has the investment benefit of every cent. Installment reporting equates the obligation to pay tax and the ability to pay it. Installment reporting does not inevitably, or even logically, mandate vesting in the seller the interim, very sizable additional benefit of a return to Mr. A on the Government's share.

We ought to tax Mr. A annually in a more appropriate way when he avails himself of the deferral privilege. In the year of sale, we can with no difficulty calculate the tax deferred, $2,500,000, and while the deferred obligation to the fisc remains outstanding we could with no greater difficulty impose on Mr. A annually a deductible excise tax at a statutorily specified rate equal, for example, to the interest rate currently charged on tax deficiencies. If that rate were 12%, and Mr. A recevies interest at a 12% rate on the P note, the Government and not Mr. A would receive the $300,000 that the tax deferral yields.

Were that system in place, the Government would be essentially indifferent to whether, on his sale of property, Mr. A receives immediate cash or deferred payment. No less important, in negotiating with the corporation Mr. A would seek the best commercial deal, cash if it is obtainable, deferred payment with the best available security only if cash is not obtainable. It is conventional but quite accurate to declare that the tax law works best in commercial transactions when it performs in a neutral way and thereby permits the parties to craft the most sensible business arrangement. taxing the privilege of deferral, in installment sale transactions, fully comports with that notion.

If at long last we may attend to present value realities in the tax law, installment sales would be a fine and productive place to start.

C. CERTAIN RELATED PARTY TRANSACTIONS: REAL PROPERTY

The Administration advances various proposals targeted to selected related party transactions, but omits one hardly less abusive. It flows from the limitation to depreciable property in section 1239.

Assume Mr. C owns a tract of land that has significantly appreciated in value. If, to maximize profit, he subdivides and improves the tract and sells the numerous parcels to customers, except as section 1237 may furnish partial relief all of his gain is ordinary income. Better advised, before subdividing Mr. A will sell the land, for an installment note and at the highest defensible price, to his spouse or to a corporation (which may be an S corporation) owned by either or both of them, the purchaser to undertake subdivision and sale and the attendant, minimized ordinary income that activity will produce. Mr. A will claim installment reporting and capital gain.

Section 1239, and with it section 453(g), ought to be amended to cover sales of land, either without limitation or, at the least, when the closely related buyer undertakes the dealer's role within some statutorily specified period of time.

D. RECEIPT OF EXTRAORDINARY DIVIDENDS BY CORPORATIONS

The problem addressed by the proposal—distribution of appreciated property to a corporate shareholder that recently has purchased the shares—is not new, but the size of the potential abuse has expanded greatly as a result of the TEFRA repeal of "old" section 346 and enactment of new sections 302(b)(4) and 311(d)(2)(A). The concern and its potential magnitude were explored in testimony before this Committee on September 22, 1983, focused on technical corrections to the TEFRA subchapter C legislation, and that path of explanation need not be walked a second time.

The Administration proposes to address the abuse, allowance of a phantom and often gigantic capital loss, with unfortunate precision. If the corporate shareholder at the time of the appreciated property distribution has held its shares in the distributing corporation one year or less, phantom loss is disallowed. If the corporate shareholder has held at least a year and a day, phantom loss is allowed in full. Thus, a "cliff" approach.

Taxpayers bent on tax avoidance are not inevitably patient, but if the rewards are sufficient they can be patient a year and a day. A very sizable capital loss, reflective of no economic loss but nonetheless available to offset current and (by carryback) past short term gains, is more than sufficient reward.

The Administration is right in appreciating that, when the shares have been held a long time, the case is distinguishable. But the Administration is, I think, wrong in embracing a cliff notion and, with it, a blueprint for tax avoidance. More sensibly, the reduction-in-basis proposal should apply with full force when stock in the distributing corporation has been held not more than one year, and thereafter should apply with diminishing force, under a phasing-down rule of the sort historically familiar in section 1250, during a period of at least a few years thereafter.

E. ACCUMULATED EARNINGS TAX

The Administration proposes once again to tinker with the accumulated earnings tax. The approach is misfocused. The entire structure of this unfortunate penalty tax is ill-starred and deserves, in at least two respects, basic reconsideration.

First, in a world in which interest rates, on tax deficiencies and indebtedness in general, are high, it is simply inconceivable to maintain, as now we do, a penalty tax on which interest commences to run, not on the due date of the corporate tax return, but rather at the remote future time at which it is finally determined that the corporation is liable for accumulated earnings tax. The corporation has little incentive to distribute current dividends, the objective of the taxing scheme, if the penalty for failure to distribute, getting caught, and finally losing in court seven or ten years hence is then to pay the penalty tax but not one cent of interest. If we are going to maintain an accumulated earnings tax, as a practical matter we waste our time unless the statute is amended to provide that, upon the final determination of a deficiency, interest will be charged at the statutory rate for the period commencing with the due date of the corporate tax return for the year to which the accumulated earnings tax deficiency relates.

Second, in a world in which the maximum corporate tax rate if 46% and the maximum individual income tax rate 50%, and in which a subchapter S election is broadly available, realistically the accumulated earnings tax targets a much narrower concern than once it did. Essentially, that concern focuses primarily on the section 243 intercorporate dividend deduction, and very secondarily (if indeed at all) on the lower rates of corporate tax imposed on the first $100,000 of annual corporate taxable income.

It would seem to me sensible, simplifying, and probably productive of some revenue as well, to inject into the statutory scheme a safeharbor dividend, assured absolution from penalty tax for any year in which the corporation, within two-and-a-half months of year end, distributes a designated dividend. Set by statute, the required dividend would equal the aggregate section 243 deduction enjoyed by the corporation that year. If the lower rate of corporate tax on first earnings is a congressional concern, the required safeharbor dividend would be the section 243 amount plus a specified percentage, perhaps 50%, of the amount by which the corporation's section 11 tax (before credits) on its first $100,000 of taxable income falls below tax computed at the full 46% rate.

A corporation would not be forced to pay the safeharbor dividend, of course. If comfortable that accumulation is required by the reasonable needs of its business, it would not distribute. But if in doubt, as so many corporations are or ought to be, a corporation might well choose to self-police, electing the modest impost to gain certainty and absolution from a potentially much greater one. It is a notion that likely would not prove fruitful under the balance of present law, but could work quite efficiently if the threat of accumulated earnings tax were bolstered by the assurance that, if imposed, the penalty tax will attract the correlative burden of a full interest charge.

II. A Misconceived Proposal: Limitations on Like-Kind Exchanges

The Administration's proposal is in two parts. The second appears flawed in a minor way. The first seems almost entirely wrong.

A. NONSIMULTANEOUS EXCHANGES: SECTIONS 1031 AND 453(f)(6)

Section 1031 is one of the many nonrecognition exchange provisions that have been part of the tax law time out of mind. It instructs that no gain or loss shall be recognized if property (other than stocks and bonds and the like), held for productive use in trade or business or for investment, is exchanged solely for property of a like-kind to be similarly held. If the exchanging taxpayer receives, in addition to assets of like-kind, cash or other property (collectively "boot"), gain is recognized up to the amount of that boot. Loss is never recognized, and it was in large part to prevent loss recognition on property swaps that Treasury long ago endorsed this statute.

In 1967 Mr. Starker entered into a land exchange agreement with Crown Zellerbach Corporation (Crown). Under the agreement, to simplify somewhat, Mr. Starker on day-one transferred Blackacre, then worth $1,500,000, to Crown. In return, Crown agreed that as Mr. Starker identified properties of like-kind over the next five years, Crown would expend up to $1,500,000 to purchase those properties and, immediately after purchase, would transfer the like-kind properties to Mr. Starker. In the interim, interest, disguised somewhat but interest nonetheless, would be earned. Over a period of just under two years, Mr. Starker identified twelve properties, Crown expended the entire account in purchasing them, and the arrangement was closed out. Relying on section 1031, Mr. Starker reported no recognized gain on the exchanges.

The Internal Revenue Service conceded that section 1031 would have applied had all exchanges taken place on day-one rather than over a period of twenty-two months. Voluminous case law required that concession. The Service, however, argued that because the exchanges were not simultaneous, section 1031 could have no application. In *Starker* v. *United States,* 602 F.2d 1341 (9th Cir. 1979), the Service was soundly rebuffed. It has faired no better since. See, e.g., *Phillip M. Garcia,* 80 T.C. 491 (1983).

It would have been astonishing had the result been otherwise. In earlier days, under one or another nonrecognition exchange provision, the Service argued that to avoid gain the taxpayer's exchange must be a simultaneous exchange. The Service lost every time. See, e.g., *Carlberg* v. *United States,* 281 F.2d 507 (8th Cir. 1960); *James C. Hamrick,* 43 T.C. 21 (1964) (acq.). When the taxpayer, seeking to claim a loss, structured a nonsimultaneous like-kind exchange, the Service speedily asserted the applicability of section 1031 and, quite properly, prevailed. *Redwing Carriers, Inc.* v. *Tomlinson,* 399 F.2d 652 (5th Cir. 1968). More than 25 years ago the Service stated the matter to perfection in a published Revenue Ruling: "Simultaneous delivery of property is not essential to an exchange. If the parties so intend, title to property delivered on one side may pass even though the contract remains executory on the other side." Rev. Rul. 57-451, 1957-2 C.B. 295.

The Administration today proposes a statutory change under which a delay of more than 90 days, between the date the taxpayer transfers Blackacre and the date the taxpayer receives Whiteacre in exchange, will not qualify for nonrecognition treatment under section 1031 (technically, the proposal is that Whiteacre will not qualify as like-kind property). The reasons given in the Administration's proposal, and the impact it would have on taxpayers and the fisc, are extraordinary.

1. Asserted reasons for change

I am a prejudiced but not entirely uninformed commentator here. Most, but happily not all, of the Treasury's asserted reasons for change, I am told, derive from an article I wrote for the 1981 University of Chicago tax papers. Those papers were reprinted that year in a widely circulated tax periodical. To facilitate the debate but avoid repetition, appended to this testimony is an excerpt of the pertinent portion of the 1981 papers.

The Treasury has included in its asserted reasons for change two facially inconsistent ones I did not catalogue, and I address them first. Both are stated to relate to administrative convenience.

Treasury announces that section 1031 properly applies to simultaneous exchanges because it there avoids valuation difficulties, a rationale that does not apply to deferred like-kind exchanges. For a large class of simultaneous exchanges the assertion is flatly wrong. Under section 1031(b), every exchange, simultaneous or nonsimultaneous, that involves boot requires valuation, both of the boot and of the like-kind property received, and if realized again is less than the amount of boot the valuation must be precise.

Treasury's second argument, that deferred like-kind exchanges raise administrative problems that requires complex solutions, is equally worthy. It is simply untrue. In 1981, two respected tax lawyers, Gersham Goldstein and Charles S. Lewis, in a widely read paper entitled Tax Treatment of Like-kind Exchanges of Property Used in a Trade or Business or for Investment, set out just how, and how simply, the solutions would be articulated in sensible regulations. See 5 Review of Taxation of Individuals 195, 276–78, 293–94 (1981). See also the portion of the attached paper headed "Mortgage and Basis Issues," 59 Taxes 886, 890–91 (1981).

The second set of asserted reasons for change, which do appear to derive from the attached paper, focuses on potentials for serious tax abuse that were not presented on the facts of the *Starker* case but could well be presented, I believed, on another day. They relate to burned-out tax shelters, basis misallocations, and a possible end-run around section 1014(c). Real concerns indeed, when I wrote in 1981.

But Treasury has neglected to remind this Committee of the rest of the story.

2. The January 1983 statutory amendment

In 1981 it had seemed to me Treasury could deal effectively with these concerns through regulations. Treasury, it appears, was less sure.[1]

In the Fall of 1982, Treasuey came to this Committee and asked you to amend section 453(f)(6)(C) for the sole and explicit purpose of making it clear that Treasury thereafter could promulgate regulations to deal fully and effectively with specific concerns—excess mortgage encumbrance, burned-out tax shelters, basis misallocations—catalouged in the Administration's current proposal.

In January of 1983, Congress made the requested statutory change. Congress made that change in § 303 of the Technical Corrections Act of 1982, P.L. 97–448. Let me make the point quite explicit: *The principal reasons for change advanced in the Administration's proposal are meaningless because you have already made the appropriate statutory amendment.* Let me quickly add that I do not suggest, nor do I for a moment believe, that Treasury in this matter is in any way venal or lacking in candor. What I do believe, and it is a sad but I fear accurate comment on the complexity of our tax law and the inadequacy of our processes, that victimized by turnovers in its personnel and a consequent lack of institutional memory Treasury simply forgot that it had already requested and obtained the legislative change appropriate to the concerns it has expressed.

3. What's left?

I think there is a further statutory amendment you might undertake, but most certainly it is not the amendment the Administration has requested. In focus is the section 1014(c) concern briefly mentioned in the Administration's submission, and while I believe regulations under the present statute can deal with it adequately—it is explained more fully in the attached paper—a brief, clear statutory underpinning would eliminate any doubt. Here is the targeted amendment I would recommend, an addition to section 1031(a):

"This section shall not apply with respect to gain realized on a non-simultaneous exchange to the extent the transferor had the right to demand or receive money or property that is not of a like-kind."

4. The impact of enacting the administration's proposal

The Administration's proposal is seriously defective for reasons that go well beyond the lack of any need for it. It would not eliminate potential tax abuse. It would create a new avenue of tax abuse and impact in a grossly unfair way on at least one class of taxpayers bent on no abusive planning at all.

The avenue of tax avoidance planning the proposal would open is an obvious one. Section 1031 largely was enacted to prevent recognition of loss when a taxpayer exchanges business or investment property depreciated in value for property of a like-kind. When Mr. A exchanges Blackacre for Whiteacre, the administration would treat Whiteacre as not of like-kind if more than 90 days intervene. Able to read so simple a road map, if Blackacre and Whiteacre each is worth $5 million and Mr. A's basis in Blackacre is $8 million, he will of course structure the exchange to defer 91 days his receipt of Whiteacre after he has transferred Blackacre. Correctly, he will then claim a deductible loss of $3 million. Of course, if value were $8 million and basis $5 million, Mr. A would structure a simultaneous exchange and avoid recognition of gain. In the practical world, therefore, what the Administration proposes is a new and wholly inconceivable section 1031 under which gain is not recognized but loss is allowed. I assume it to be equally inconceivable that Congress would enact a statute of that sort.

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[1] Treasury's uncertainty as to its authority to issue effective regulations, under the pertinent statute as originally written, stemmed from the considerations that are set out in the attached paper in footnote 27 on pages 889–90.

Who, in the real world, will be adversely affected if the Administration's proposal were enacted?

Certainly not the wealthy and well-advised, for two reasons that ought to be apparent. First, in an inflationary world a long-deferred *Starker* exchange is a foolish way to avoid recognition of gain. If I owned Blackacre worth $10 million in 1974, transferred it then for a right to designate exchange property worth $10 million at the time of designation, and did not designate Whiteacre until 1984, I have participated in a very bad deal. If Whiteacre is worth $10 million in 1984, it likely was worth less than two-thirds of that amount ten years earlier. Taxes notwithstanding, I would have faired far better had I elected in 1974 to receive immediately Whiteacre plus $3,400,000 or thereabouts in cash. The rich did not become rich by engaging in silly transactions.

Second, were I nonetheless to insist on a long-term designation right, the Administration's proposal if enacted would raise no bar. I would simply enter into a long-term ground lease of Blackacre with the other party and an agreement that, when within the next ten years I identify a like-kind property, the other party will purchase it expending up to $10 million and then will make a simultaneous exchange of the purchased property for my interest in Blackacre. Should I fail to designate property with the ten years, the agreement would allow the other party the option either to purchase Blackacre for $10 million or to maintain the ground lease in force.

Who, then, would be adversely affected, if not the rich and well-advised?

Mr. D, A resident of Chicago, owns and on evenings and weekends manages a small apartment building worth $500,000. His basis in the property is very low, and the building represents his only asset of value. He is 65 years of age and wishes to or must move to a warmer climate. Mr. D would like to exchange the Chicago apartment building for a Florida apartment building and thereafter manage it. Unrelated B Corporation is interested in acquiring the Chicago building. Mr. D has not yet located an appropriate apartment building in Florida and wishes to proceed very carefully. Selection of the wrong property could well prove ruinous. A non-simultaneous exchange with B Corporation is the sensible course. Mr. D will transfer the Chicago building to B, move to Florida, test the market, and carefully select an appropriate building which B will purchase for $500,000 and then convey to Mr. D. From beginning to end this procedure may absorb four months or six months or ten months or longer. While Mr. D in his own interests wishes to move with dispatch, at inception there is no way he can know the timetable.

Mr. D exemplifies the class of taxpayers the Administration's proposal will adversely affect. The law currently taxes those who receive cash at the end of the trail, requiring recognition when the cash is actually received. The Administration's proposal would tax Mr. D, in the year he receives the Florida building, at the very moment it becomes clear that has has no money with which to pay that tax.

It seems to me impossible to conjure up any rationale tax policy to support that result.

B. EXCHANGES OF PARTNERSHIP INTERESTS

Developing case law has extended section 1031 nonrecognition of gain to certain exchanges of partners' interests in different partnerships. Conceiving this development over generous, the Administration proposes an amendment confirming that the nonrecognition provision for like-kind exchanges shall not apply to exchanges of partnership interests.

I think the Administration's approach reasonable is broad, but unnecessarily rigid. Allowing section 1031 treatment to exchanges of interests in publicly traded partnerships, or in closely-held partnerships engaged in dissimilar activities, is hardly inappropriate. But an exchange of limited partnership interest in two closely-held partnerships the assets and activities of which are of like-kind presents a case of different quality. If the exchanging taxpayers owned undivided interests in the underlying assets, rather than interests through partnerships, section 1031 would govern. If the patnerships exchange their properties, or undivided interests in each property, section 1031 will govern.

It would be sensible to leave room for amelioration by regulations. The Administration's proposal, when committed to statutory form, ought to bar section 1031 treatment of exchanges of interests in different partnerships except to the extent provided by regulations. A helpful committee report could make clear an anticipation that, when neither partnership is publicly traded, the partnership interests exchanged are of equivalent quality, and the partnerships' operations and assets are of like-kind, the regulations will authorize nonrecognition treatment and thereby allow the partners to do directly that which the law permits them to accomplish indirectly.

EXCERPT FROM

M. GINSBURG,

RETHINKING THE TAX LAW
IN THE NEW
INSTALLMENT SALES WORLD,

59 TAXES 885 (1981)

Like-Kind Exchanges

Let us turn our attention for a few minutes away from Mom and her convertible installment note and examine a facially similar but, to my mind, quite different property disposition.

Dad long has held for investment Blackacre, unimproved real property, at a basis of $200,000. Blackacre is worth $1 million and is unencumbered. If Dad transfers Blackacre to B corporation in simultaneous exchange for Whiteacre, also encumbered real property worth $1 million which Dad thereafter will hold for investment, he will recognize no gain on that exchange and will hold Whiteacre at a basis of $200,000.[23] If B has not previously owned Whiteacre and purchases it solely to make the exchange, that is of no moment to Dad. His nonrecognition treatment under Section 1031 is independent of B's tax treatment.[24]

Nonsimultaneous Exchanges

Assume instead that while B is anxious to obtain Blackacre at once and Dad is quite willing to part with it in exchange for real property of like-kind, Dad has not yet identified the specific property or properties he would accept in exchange. Advised by wily counsel, the parties enter into a variant of the notorious *Starker* transaction,[25] a variant I will call the "property-only case." In 1981 Dad transfers Blackacre to B corporation and, in return, B promises that if by the end of 1984 Dad identifies and designates one or more parcels of like-kind investment real property worth $1 million in the aggregate, B promptly will use its best efforts to purchase the designated land and, having purchased, promptly will transfer the land to Dad together with interest (in cash) computed at the rate of 9 percent per annum.[26] In this property-only case, the agreement between Dad and B goes on to provide that if Dad fails to designate $1 million in property before the close of 1984, B (*not* Dad) may elect to pay the undesignated balance to Dad in cash or to continue the property designation arrangement in force from year to year. In 1981 Dad designates no property. In 1982 he finds Whiteacre. B purchases it for $1 million and promptly transfers Whiteacre to Dad together with a cash payment of interest. How should Dad treat these events on his 1981 and 1982 tax returns?

Property-Only Case

In 1981 Dad disposes of Blackacre and, it turns out, receives nothing tangible for it until after the close of the year. That arrangement meets the definition of an "installment sale" in new Section 453(b)(1), or at least it does unless we are prepared to chase ourselves round peculiar circles to no meritorious purpose.[27] Automatically

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[22] The last three of these assumptions also were made in The American Law Institute's current Federal Income Tax Project—Subchapter C. The Project's proposals for the taxation of corporate acquisitions are contained in Tentative Drafts No. 1 (1977) and No. 5 (1980), and its proposals relating to corporate distributions in Tentative Draft No. 2 (1979). When these Drafts were written Sec. 1023 was still in the Code. The Project would divorce almost entirely corporate level tax treatment and shareholder level tax treatment, an approach that would eliminate present law's umbrella concept of a "reorganization." It is not at all clear, however, that the Project would approve nontaxable exercise of her installment obligation conversion right by Mom (with preservation of her $200,000 basis), and certainly not clear the Project would approve this treatment after the repeal of Sec. 1023. Nor is it entirely clear how the Project would treat P (and X) if Mom were afforded nontaxable conversion. Undoubtedly the Project Reporter and Consultants were aware of the current taxable disposition rule and, viewing a change in that rule as beyond the scope of their work, probably would have continued to tax Mom and afford P a purchase price basis of $1 million.

[23] Sec. 1031(a), (d).

[24] See *Alderson v. Commissioner*, 63-2 USTC ¶ 9499, 317 F. 2d 790 (CA-9).

[25] *Starker v. United States*, 79-2 USTC ¶ 9541, 602 F. 2d 1341 (CA-9).

[26] In *Starker* itself an attempt may have been made to disguise the interest factor but the court was not misled. If an agreement for deferred payment or delivery fails to specify stated interest, Sec. 483 will fill the gap.

[27] Here are some of the issues. Sec. 453(b)(1) defines an installment sale to mean "a disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs." Sec. 453(f)(3) states that the term "payment" does not include the receipt of evidences of indebtedness of the person acquiring the property, but Sec. 453(f)(4) overrides in providing that receipt of an evidence of indebtedness which is payable on demand shall be treated as receipt of payment. At least in theory, Dad could identify, demand and receive Whiteacre before the close of 1981, although in reality there may be no assurance that

(Continued on following page.)

on the installment method,[28] Dad reports nothing in his 1981 tax return since, in that year, he has been paid nothing.[29]

In 1982 Dad receives Whiteacre worth $1 million. If Section 1031(a) applies to this "delayed exchange" of Blackacre for Whiteacre, Dad will recognize no gain and will hold Whiteacre at a basis of $200,000. I think this the right answer under current law. Decided prior to the 1980 Act, *Starker* itself did not implicate old Section 453.[30] The *Starker* court held Section 1031 applicable to a delayed exchange of like-kind property and the Service, which previously had reached the same conclusion, thereafter reversed field and announced the contrary.[31] Arguably, post-1980 Act application of the installment method affords the Service a graceful opportunity to reverse its position again,[32] but whether or not this is so the Service ought to reverse.

Recognition of Loss.—I think this the wise course for all sorts of reasons. Not every investment appreciates in value. If Dad owned Blackacre, current value $1 million, at a basis of $3 million, his depression upon discovering a simultaneous exchange for Whiteacre allows him no current loss under Section 1031(a) will turn to amazed joy upon learning that interposing a carefully designed exchange delay produces a current $2 million loss. Few have heretofore asserted the Service conceives its mission as the relief of taxpayer anxiety, and while there may be much to be said for the notion I would not have selected this as the case in which to say it. There may of course be another way to deal with the recognition of loss issue,[33] but there is still more to the *Starker* problem in an installment sale world.

Mortgage and Basis Issues.—For one thing, Blackacre may be mortgaged property. If mortgage is in excess of basis, under the installment sale regulations[34] the excess is treated as immediate payment to Dad. Under Section 1031, if Whiteacre is encumbered by a mortgage of equal or greater principal amount Dad recognizes no gain. In a delayed exchange transaction, Dad has not yet received but later may designate and receive a heavily encumbered Whiteacre. And, what of the Blackacre mortgage that is within Dad's $200,000 basis? Under the installment method rules the other party's assumption triggers no gain to Dad.[35] Under the like-kind exchange rules of Section 1031, the relationship of mortgage and basis is irrelevant.[36]

(Footnote 27 continued.)

B can so quickly purchase Whiteacre, whether for $1 million or at all. On the other hand, B may already own Whiteacre and, while Dad could designate and receive it before the end of 1981, he is not at all sure Whiteacre is the property for him and does not wish precipitously to abandon the opportunity to make a better acquisition for which opportunity he has bargained. Cf. *Patterson v. Hightower*, 57-2 USTC ¶ 9789, 245 F. 2d 765 (CA-5 1957). Turning to the other side of things, if on closing date Dad had received from B at least a small parcel of investment real property together with at least $1 in cash (not as a payment of interest), Sec. 453(f)(6) would be in point (as it might be found in point even absent simultaneous exchange delivery of investment real property and cash). Sec. 453(f)(6)(C) states that the term "payment" does not include receipt of like-kind property in an exchange described in Sec. 1031(b). If, as in the example case, it turns out that all of the property received by Dad after the close of 1981 is like-kind property, it might be argued that no "payment" has been received after the close of 1981 and therefore the transaction does not meet the definition of an installment sale contained in Sec. 453(b)(1). Of course, if under the agreement with B Dad is to receive a cash payment of even $1 (other than as interest) after the close of 1981, the statutory definition of an installment sale clearly is met. The "demand obligation" concern, should it really concern anyone, could be similarly attended to. The agreement between Dad and B would provide that Dad cannot designate any property before the close of 1981.

[28] Sec. 453(a). Prior to the 1980 Act, under old Sec. 453(b) installment reporting of a future payment sale of real property or a future payment casual sale of personal property required the taxpayer's affirmative election. Under current law installment method treatment is automatic, subject to the taxpayer's affirmative election out of that treatment. Sec. 453(d).

[29] Sec. 453(c). With respect to "payment," see Sec. 453(f)(3) & (4) and the discussion of those provisions in footnote 27.

[30] Prior to the 1980 Act old Sec. 453 required affirmative election of the installment method. The taxpayer in *Starker* did not attempt to make that election.

[31] In Rev. Rul. 57-451, 1957-2 CB 295, the Service publicized its conclusion that "simultaneous delivery of property is not essential to an exchange. If the parties so intend, title to property delivered on one side may pass even though the contract remains executory on the other side." This nonrecognition conclusion was reached under Sec. 1036(a), a provision on this point indistinguishable from Sec. 1031. See Sec. 1036(b) (cross reference). Subsequently, in LTR 7938087 (CCH IRS LETTER RULINGS REPORTS No. 134, September 25, 1979), without citing Rev. Rul. 57-451 and citing instead authority having nothing to do with the matter, the Service explicitly reached the same nonrecognition result under Sec. 1031. Later, however, after the *Starker* decision, the Service reconsidered and, again without making any reference to Rev. Rul. 57-451, declared Sec. 1031 does not apply to a delayed exchange of like-kind property. CCH IRS LETTER RULINGS REPORTS No. 195, November 26, 1980, LTR 8046122.

[32] See Sec. 453B(a), announcing that on the satisfaction at other than face value, distribution, transmission, or other disposition of an installment obligation, gain or loss "shall be considered as resulting from the sale or exchange of the property in respect of which the installment obligation was received." In Dad's case, that property was Blackacre and what Dad is deemed to have received in exchange for it is Whiteacre. See Sec. 453B(a)(1).

[33] Not surprisingly, when the delayed exchange issue has arisen in a loss context, the Service ignoring nonsimultaneity has successfully argued for the application of Sec. 1031(a). See *Redwing Carriers, Inc. v. Tomlinson*, 68-2 USTC ¶ 9540, 399 F. 2d 652 (CA-5). The court did not discuss the delayed exchange issue.

[34] Reg. § 15A.453-1(b)(3)(i).

[35] This assumes, as almost always will be the case, the mortgage on Blackacre is "qualifying indebtedness" within the meaning of Reg. § 15A.453-1(b)(2)(iv).

[36] Under Sec. 1031, if the mortgage on Blackacre exceeds the sum of the mortgage on Whiteacre (the like-kind property received in exchange) and any cash paid by Dad to the exchanging party, that excess is "boot"

For another thing, there is the matter of allocating Dad's basis in Blackacre among like-kind properties received in the future. If Section 1031 is applicable to a delayed exchange and Whiteacre, the first like-kind property Dad receives, has a net fair market value of only $500,000, at what basis will Dad initially hold it? The installment method's ratable recovery of basis concept urges $100,000.[47] An isolated reading of Section 1031, however, would suggest that Dad will hold Whiteacre at a basis of $200,000.

These are hardly insignificant matters. In writing regulations under new Section 453(f)(6), the Treasury Department can resolve them in a manner at once reasonable and protective of the fisk.[48] But the Treasury can furnish this guidance only if it first declares Section 1031 applicable to a property-only delayed exchange. If Treasury adheres to a contrary conclusion, it can hardly promulgate a regulation designed to harmonize the rules of Sections 453 and 1031. But, armed by the *Starker* decision aggressive taxpayers will remain fervent believers in Section 1031 treatment and, aggressive still, in the absence of Treasury direction likely will resolve mortgage and basis issues to their advantage. In the end the Service will do well enough if the courts decline to follow *Starker*, but in an audit lottery world the revenue probably will take an awful bath if the courts do not turn their backs on *Starker*. If I were King, or at least Commissioner, I would not think it wise to put all my fragile eggs in that litigation basket.

Limited Section 1014(c) Involvement.—An ordinary like-kind exchange does not implicate Sections 691 or 1014(c). Like Blackacre, Whiteacre is run of the mine property and should Dad die moments after the exchange is completed his estate and beneficiaries are also beneficiaries of a stepped up basis. But, should Dad embark on a delayed Section 1031 exchange and expire in mid-passage, his successors will pay a price. The contractual right to designate and receive property, an installment obligation, is a Section 691 item[49] and Section 1014(c) will deny a step up in basis. On the other hand, if Dad designates and receives Whiteacre before the final curtain, Section 691 will not come into play and Section 1014(a) will perform its usual service.

Cash Option Case

Let us now shift the facts. Dad's delayed exchange agreement provides that if he has not designated $1 million in like-kind properties by the end of 1984, B corporation will pay him the balance in cash on January 1, 1985. I will call this one the "cash option case." It seems to me quite different from the property-only case we have just considered and quite different from a simple contingent right to receive additional P shares in a reorganization, but closer to the convertible installment obligation we first reviewed. While I believe the Service would be well advised to concede Section 1031 treatment in the property-only case and profitably invest its time designing sensible regulations, I am if anything stronger in the belief that the Service should oppose the application of Section 1031 to the cash option case. Installment treatment yes, nonrecognition treatment no.

I come to this with mortality once again in view. Consider the following sub-class of the cash option case.

Major Section 1014(c) Involvement.—Dad transfers Blackacre to B corporation and receives in return B's $1 million 10-year note bearing interest annually payable at the prime rate. The note carries one special feature. At any time during the 10 years, Dad may designate like-kind property worth $1 million and B, if it does not already own the designated property, will acquire it and promptly transfer the designated property to Dad in early satisfaction of the note obligation. You may assume, if you like, that Dad has scant interest in acquiring another parcel of real property but a substantial interest in the well-being of his heirs. Five years later, rightly fearing impending demise, Dad designates and receives Whiteacre, holds it for investment during his waning days, and shuffles off. With all deliberate speed, Dad's executor sells Whiteacre to someone, perhaps B corporation,[50] for $1 million in cash.

Putting the matter at its simplest, I view application of Section 1031 to the cash option case as a somewhat complicated way of repealing Section 1014(c) for the benefit of wealthy and well advised real estate investors. I conceive no good reason to do this. Were Congress to reinstate Section 1023, application of Section 1031 to a cash option case would not seem particularly disturbing for, unlike Mom's sale of X corporation's stock in exchange for P's convertible note in which both Mom's and P's tax treatment are in

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requiring gain recognition (assuming sufficient gain realized on the exchange) without regard to Dad's basis in Blackacre.

[47] Blackacre is worth $1 million and Dad's basis in it is $200,000. Since Whiteacre is worth $500,000, one-half the value of Blackacre, under a ratable recovery approach Dad initially would allocate only one-half his $200,000 Blackacre basis to Whiteacre.

[48] Sensibly, I think, the regulations should provide that mortgage in excess of basis is immediate "payment" on a delayed like-kind exchange, that basis will be proportionately allocated and not isolated on the first like-kind property received, and that when all like-kind properties have been received and more than one of them is encumbered Dad's within-basis mortgage on Blackacre will be spread among those encumbered like-kind properties in proportion to the mortgage on each. For a further discussion of certain of these issues, see Goldstein and Lewis, "Tax Treatment of Like-Kind Exchanges of Property Used in a Trade or Business or for Investment," 5 *Review of Taxation of Individuals* 195, 270-95 (1981).

[49] Sec. 691(a)(4)(B) treats as a right to receive an item of gross income in respect of the decedent an installment obligation reportable by the decedent on the installment method under Sec. 453.

[50] Cf. *Weir v. Commissioner*, 40-1 USTC ¶ 9200, 109 F. 2d 996 (CA-3), cert. den., 310 U. S. 637 (1940).

issue, in the like-kind exchange arena B's tax consequences and Dad's are independent and Section 1014 is the sole focus of concern. But a concern assuredly it ought to be.

Recognition of Loss.—Perhaps so, but what about a sale at a loss? Suppose Dad, entering into one sort of cash option transfer or another, held Blackacre at a basis of $3 million rather than $200,000? Not an easy one I fear. Perhaps it is best to start with what appears clear and slide down hill from there.

It seems clear that this is not a case to which the installment method applies. Although B's "property or cash" promise may constitute an installment obligation and the transaction an installment sale within the meaning of Section 453 (b)(1), the installment method deals with and defers income recognition, it does not deal with and does not defer the allowance of loss.[41] From which it follows that Section 691, and in turn Section 1014(c), have no application when there is no gain to recognize as payments are received.[42] Sadly, we have come to the end of clarity.

If the Service were prepared to view every nonsimultaneous exchange of like-kind investment or trade or business property as a Section 1031 exchange, the loss problem would be no problem at all. Under that regime, on the date Dad transfers Blackacre all the events necessary to allow a loss have not occurred. But, to protect Section 1014(c) in profitable cash option cases, the Service ought not embrace that convenience.

Step Transaction.—If Dad transfers Blackacre and very promptly designates and receives Whiteacre, the Commissioner can seek to impose Section 1031 treatment and disallow loss under a step transaction approach. History tells us that in these impatient circumstances the Commissioner is likely to succeed.[43] If Whiteacre is worth less than Blackacre and the contract remains alive for the balance, it should be open to the Commissioner to argue bifurcation, a current step transaction Section 1031 exchange of an undivided interest in Blackacre. Of course, if the Commissioner can argue step transaction when basis is greater than value, the taxpayer can argue step transaction when basis is below value. But in this Monday transfer, Wednesday receipt sort of case, that ought not unduly concern us. If we are truly dealing with a step transaction, as on those facts we seem to be, nonrecognition of gain or loss is the right answer and, more to the instant point, an end run around Section 1014(c) rather clearly is not the taxpayer's objective.

Does current law offer any other viable approach to the recognition of loss problem in a cash option case? I rather doubt it. Returning to our review of Mom's sale of X corporation shares for P's convertible note, the cash option arrangement might be similarly viewed. B corporation has obligated itself to pay cash on a future date, either absolutely or at Dad's option, and has further obligated itself to pre-pay in property at Dad's election. The final clause of Section 453B(a) [44] might be interpreted to confer Section 1031 treatment on a subsequent like-kind receipt. But, once again, if that is so in the loss case it is no less so in the gain case. For the reasons we have explored, this sort of loss cure brings on a far worse gain disease.[45]

A Summary in Context

Before moving on to the next set of post-1980 Act installment sale problems, let me try to place the set we have been exploring in a larger context.

Under a tax law that neither triggers gain at death nor requires generally a carryover of historic basis to the decedent's successor, there is a vital relationship between an installment sale of appreciated property and preservation of the seller's basis in the installment obligation after the seller dies. The installment method, linking payment and recognition of gain to receipt of the cash with which to pay tax, comports with sensible tax policy. The sanctioning of any arrangement permitting an installment seller, for the benefit of his heirs, to metamorphosize tax deferral into tax forgiveness does not comport with sensible tax policy. The issue is major and protection of Section 1014(c) merits top rung on the ladder.

Important policies, both tax and economic, are served by the tax-free exchange and basis preservation notions exemplified by Section 1031 and the corporate reorganization provisions. It is for Congress to announce the classes of exchanges to which nonrecognition treatment shall be awarded, and Congress has done so in Section 354, Section 1031 and elsewhere in the Code. The nonrecognition exchange rules operate in a manner very different from the installment method rules in that a stepped up basis at death under Section 1014(a) is available when the taxpayer dies after the nonrecognition exchange has been completed. There is thus no linkage between the tax-free exchange and Section 1014(c)'s carryover basis at death. Everyone understands this and, we may safely assume, Congress wishes it so.

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[41] See Rev. Rul. 70-430, 1970-2 CB 51; *Martin v. Commissioner*, 3 USTC ¶ 997, 61 F. 2d 942 (CA-2 1932).

[42] Sec. 691(a)(4) refers to an installment obligation "reportable by the decedent on the installment method under section 453."

[43] *Redwing Carriers, Inc. v. Tomlinson*, 68-2 USTC ¶ 9540, 399 F. 2d 652 (CA-5).

[44] See footnote 32, above.

[45] In a gain situation the approach seems pernicious indeed. A taxpayer who has sold appreciated investment property for an ordinary cash payment installment obligation could later bargain to receive payment in like-kind property and claim Sec. 1031 nonrecognition treatment. The taxpayer would make that claim, in practical effect, by failing to report anything on his tax return. In promulgating regulations under Sec. 453B(a), the Treasury Department would be well advised to announce that the final clause of that provision does not import Sec. 1031 into the disposition equation when the installment obligation calls for payment in cash.

A taxpayer prepared to dispose of appreciated property and reinvest the proceeds, if unwilling to pay tax on the disposition and have less to reinvest, in qualifying circumstances can reinvest 100%. The model case is the so-called three-party like-kind exchange in which B purchases Whiteacre from a third person and immediately transfers it to Dad in exchange for equally valuable like-kind Blackacre. Without regard to B's tax treatment, Dad is covered by Section 1031(a). Congress has not seen fit to alter this judge-made rule, and one may fairly speculate Congress sees the continued full investment as a good thing. Historically the Commissioner has viewed arrangements of this sort with greatly modified rapture. But, whatever the grounds of his distaste, they cannot reasonably include serious difficulty of tax administration for by definition the basis and holding period of Blackacre trace directly to Whiteacre. There is, however, a different objection to the three-party like-kind exchange and equivalent devices that validly can be raised. Stated simply, these transactions are inelegant, complex, unnecessarily expensive, call for a level of professional advice that is most readily available to the urban wealthy, and require that a rather baroque commercial transaction perform the function of a tax law election.

In special circumstances Congress allows tax-free rollover of the cash proceeds of a property disposition. When appreciated property is compulsorily or involuntarily converted into money or dissimilar property, the taxpayer may avoid gain recognition [46] and, in effect, preserve historic basis [47] by timely reinvestment in property similar or related in service or use. If the taxpayer sells his or her principal residence at an otherwise taxable gain,[48] timely reinvestment avoids recognition of that gain and preserves historic basis.[49] These rollover provisions are analytically similar to the nonrecognition exchanges exemplified by Section 1031 in that there is no linkage to Section 1014(c) and there is an automatic tracing of basis from old property to new. The rollover provisions are, however, superior in permitting commercial matters to proceed in an ordinary way, cash receipt and cash reinvestment, contemplating nothing vaguely equivalent to Section 1031's three-party like-kind exchange.[50]

It is conventional to view a qualified employee pension trust as a rollover arrangement since the trust's sale of appreciated investments and reinvestment of proceeds occasions no current tax liability.[51] The characterization is somewhat misleading, however, since the employer's contribution of appreciated investment property to the trust results in immediate recognition of gain to the employer.[52] Of course, the employer's contribution deduction then is measured by the property's fair market value, not its former low basis, and thus the gain is washed out by the increased deduction. Indeed, more than washed out since, often, the gain is long-term capital gain. In practical effect, therefore, the arrangement proves a bit better than a simple rollover.

Turning to *Starker* and all that, if the taxpayer's sole right is to receive in the future qualifying property—property the receipt of which in a simultaneous exchange would attract nonrecognition treatment and basis preservation—there is no impelling reason of tax policy to require recognition of gain when qualifying property is later received. And there is ample reason to deny the taxpayer a threshold loss when Blackacre, the property he is conveying, is worth less than its basis. Application of Section 1031 or other nonrecognition provision in the gain case allows the taxpayer, once qualifying property has been designated and received, to hold for basis step up at death. But that ought not concern us here since Congress has established no linkage between nonrecognition provisions and Section 1014(c). Far more significant than inherited basis in evaluating a nonsimultaneous property-only exchange is a different consideration, one both practical and conceptual. A tax-free investment rollover is an attractive notion because it permits events to proceed in a sensible commercial way. Ordinarily, the old property is disposed of, proceeds are received, new property in due course is found, the new property is purchased, and the taxpayer then uses or occupies it. A simultaneous three-party or even four-party like-kind exchange is an unattractive business because, functioning in a manner anything but neutral, the tax law forces the parties to pursue an otherwise senseless commercial route. Viewed in this light, the nonsimultaneous property-only exchange is simply a more sensible way to proceed.

But matters take on a different cast, I believe, when the taxpayer has the right or option to receive cash or other nonqualifying property. Here Section 1014(c) may be very much in the picture, lurking in the background initially but ready to take center stage as events proceed. I commenced with the argument that protection of Section 1014(c), thereby preventing conversion of recognition later to recognition never, is the paramount issue. If that argument is valid, the cash option case should be awarded installment method treatment but not nonrecognition exchange treatment. It is perhaps a misfortune of present law that this approach to the gain side remits the Commissioner only to a step transaction contest when loss is in issue. But if the arrangement is not in fact a step transaction for the exchange of like-kind properties, it is by no means clear the taxpayer should be denied the loss while it is rather more clear that the larger problem resides on the gain side.

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[46] Sec. 1033(a)(2).

[47] Sec. 1033(a)(2)(A).

[48] Cf. Sec. 121, establishing a one-time exclusion from gross income of certain gain from sale of a principal residence by an individual who has attained age 55.

[49] Sec. 1034. If the taxpayer's adjusted sale price of the old residence exceeds the cost of purchasing the new residence, gain in the amount of the difference will be recognized unless Sec. 121 excludes that gain from gross income.

[50] See, to similar effect, Sec. 337(e) (special rule for involuntary conversions).

[51] Secs. 402(a), 501(a).

[52] See *United States v. General Shoe Corporation*, 60-2 USTC ¶ 9678, 282 F. 2d 9 (CA-6).

Mr. GIBBONS. Our next witness is Mr. Aidinoff.

STATEMENT OF M. BERNARD AIDINOFF, COUNSEL, SECURITIES INDUSTRY ASSOCIATION

Mr. AIDINOFF. Thank you.

Mr. Chairman, members of the committee, my name is M. Bernard Aidinoff. I am a partner in the New York City law firm of Sullivan & Cromwell. I am appearing today on behalf of the Securities Industries Association.

I would like to concentrate on two items: The proposals relating to the deduction allowed a corporation for dividends received from another corporation, and the proposal relating to market discount on outstanding bonds.

First, the dividends-received deduction. The deduction for dividends received by domestic corporation for another has been a classic feature of our tax law. To the best of my knowledge, no one has ever suggested that this deduction is a preference incentive or subsidy. The dividends-received deduction is available only to the extent of dividends received. In that sense, it is not a tax shelter, and can never be used as an offset against other taxable income.

Moreover, the dividends-received deduction, as it name implies, is available only with respect to dividends. That means distributions out of earnings that have already been taxed.

So that in analyzing the various proposals with respect to the dividends-received deduction, one must realize that one is really dealing with income which is being taxed before distribution to individuals at a rate of 49.726 percent, rather than just merely 6.9 percent.

It is for this reason that we believe that any legislation in the area of abuse should be very specifically targeted.

The SIA believes that the current 16-day required holding period is sufficient to insure that corporations receiving the dividends-received deduction are at risk for a sufficient period of time with respect to the underlying stock to prevent planning for so-called tax arbitrage, and that the few instances of extremely large dividends such as the dividend on Chrysler preferred received notoriety out of all proportion to their frequency.

It is because they are so infrequent and really such a nonproblem that the SIA supports the administrative proposal to require a greater-than-one-year holding period for so-called extraordinary dividends to handle that type of problem when it comes up.

We would suggest, however, that in looking at the Treasury's proposal: One, that the measurement of an extraordinary dividend be made with respect to the fair market value of the stock at the time the dividend is declared or goes ex-record or goes ex-div, rather than using the basis. Two, that the special 20-percent rule is not necessary. All that one needs is the 10-percent limitation on dividends within a 90-day period, which is reduced to 5 percent in the case of preferred.

The administration's proposal provides that the required holding period for a dividend-paying stock for a taxpayer to receive the dividends received deduction would exclude any period during which the taxpayer is a grantor of an in-the-money option with respect to the stock, regardless of whether the option is deep in the money or not.

The SIA strongly opposes this modification to the present rules under 246(c)(3), which prevents the accrual of holding period during the time that the taxpayer is essentially in a short position. Quite frankly, we believe that the use of concepts from the straddle area is totally inappropriate in the case of the dividends received deduction.

The offsetting position concepts of section 1092 just are not applicable here. The purpose of the holding period requirement is to insure that only one dividend receives the dividends received deduction and current law basically handles that well.

With respect to the Treasury's proposal with respect to the nondeductibility and capitalization of payments in lieu of dividends in cases where short sales are not held open for specific periods, the SIA supports those proposals. The area in which we have the greatest difficulty are the proposals to limit the deduction for interest paid or accrued on debt which but for an investment in stock could not have occurred.

One, we think that it is going to be very, very difficult to apply such a rule, except possibly in the case of nonrecourse debt. Two, if it is applied in any meaningful way it is going to really destroy the markets for preferred stocks. We think that when one reflects on the fact that the dividend has already borne a full corporate tax, there is no reason for disallowing an interest deduction.

With respect to market discount, the Treasury is proposing a gain recognized on the sale or retirement of a bond be treated as interest to the extent of accrued market discount. Gain in excess of accrued market discount would continue to be treated as capital gain.

I would like to make only two points on this: One, that inconsistently the Treasury is proposing no change when there is a loss on the sale of a bond because interest rates have gone up rather than down. Two, it is important to note that interest rates may—or market discount is not always due to the fact that interest rates have changed. Market discount may very well be due to the market's perception of increased risk, the likelihood of bankruptcy, and inflation itself.

There are many problems in this area which nobody has had the chance really to fully consider the implications. I suggest you go very, very slowly in this area.

The SIA is prepared to help your staffs in any way that it can. Thank you.

Mr. GIBBONS. Thank you, sir.

[The prepared statement follows:]

STATEMENT OF M. BERNARD AIDINOFF, ON BEHALF OF SECURITIES INDUSTRY ASSOCIATION

SUMMARY

(1) The purpose of the deduction for dividends received by a corporation from another is to avoid excessive taxation of income earned by a corporation. The deduction is available only with respect to dividends, which reflect previously taxed income. The deduction therefore has none of the elements of a tax shelter identified by the staff of the Joint Committee on Taxation, namely the realization of tax sav-

ings with respect to other income and the receipt of tax-preferred or tax exempt income.

(2) The SIA generally supports the Treasury proposal requiring a greater than one year period for extraordinary dividends. The three technical suggestions made are:

(a) The use of basis of the underlying stock to determine whether a distribution is an extraordinary dividend rather than fair market value immediately before the ex-dividefd date will create non-uniform treatment of differeft shareholders and will be more difficult to administer;

(b) The 5% and 10% tests for an extraordinary distribution are reasonable, but the inclusion of distributions received during a year which exceed 20% of the basis of the stock creates many measurement problems and should be dropped;

(c) The modification of the holding period rules to exclude any period during which the taxpayer has written an in-the-money call or entered into any other position which substantially diminishes its risk of loss is not justified.

(3) The SIA strongly opposes the disallowance of interest paid or accrued on debt which would not have been incurred but for the investment in dividend yielding stock.

(a) The "but for" test is of uncertain scope and could be interpreted to deny an interest deduction whenever a taxpayer could have borrowed less by selling some of its portfolio stock. In the absence of any effective date provision protecting outstanding issues, there would be a significant market impact.

(b) The use of leverage to finance an acquisition by a corporation of dividend yielding stock only transfers the interest deduction from one corporation to another. So long as the corporation is at risk with respect to its investment as it clearly would be in the case of a full recourse borrowing to purchase common stock of another corporation, no deduction should be disallowed.

(c) If the proposal is enacted, the statute or Committee report should make it clear that interest on debt incurred to finance inventory will not be disallowed. No other industry is required to capitalize interest incurred to finance its inventory.

(4) The SIA has great reservations about the proposal to treat accrued market discount as interest.

(a) Market discount not only reflects the time value of money, but may also reflect changes in risk of the investment and inflation.

(b) Status of an amount as interest has implications for many purposes of the Internal Revenue Code, and further study is required on the implications of the proposal.

STATEMENT

Mr. Chairman and Members of the Committee, my name is M. Bernard Aidinoff. I am a partner in the law firm of Sullivan & Cromwell in New York City. I am appearing today on behalf of the Securities Industry Association. SIA represents over five hundred leading investment and brokerage firms headquartered throughout the United States which collectively account for approximately 90% of the securities transactions conducted in this country. The activities of SIA Members include retail brokerage conducted on behalf of 30 million individual shareholders, institutional brokerage, over-the-counter marketmaking, various exchange floor functions and underwriting and other investment banking activities conducted on behalf of corporations and governmental units at all levels. Because of their role in the capital markets, SIA members are in a position to recognize the impact of tax policy on the capital market as well as on investment decisions by corporations and investors.

There are a number of revenue proposals continued in the Administration's fiscal year 1985 budget which will affect the securities markets. The issues relating to stock options, commodity options, and other option products were the subject of prior hearings before this Committee, and I have participated in discussions during the past months with the staff on these matters. There are two items I wish to discuss today—the proposal relating to the deduction allowed a corporation for dividends received from another and the proposal relating to market discount on outstanding bonds.

DIVIDENDS RECEIVED DEDUCTION

The deduction for dividends received by a domestic corporation from another has been a feature of the U.S. revenue laws since the Revenue Act of 1918, and it is a fundamental aspect of the "classical" two-tier system of taxing corporations and their shareholders. To the best of my knowledge, no one has ever suggested that this deduction is a preference, incentive, or subsidy. Before considering some of the technical aspects of the Treasury's proposal therefore, let me make a few observations.

First, the dividends received deduction is available only to the extent of dividends received and in no event may it otherwise exceed the recipient's taxable income. I make this comment because I consider it unfortunate that this important issue is being considered with other "tax shelter" proposals. The pamphlet prepared by the staff of the Joint Committee on Taxation for this hearing described a tax shelter as an investment in which a significant portion of the investor's return is derived from the realization of tax savings with respect to other income, as well as the receipt of tax-favored (or potentially tax exempt) income from the investment itself. The dividends received deduction by itself can never be used to offset other taxable income, one of the hallmarks of a tax shelter. Indeed the dividends received deduction can often be "wasted" where the taxpayer has unrelated losses.

Moreover, the dividends received deduction, as its name implies, is available only with respect to dividends. The point here is that dividends which are distributed out of earnings and profits of the distributing corporation reflect previously taxed income. Thus, it is simply wrong to focus on the 6.9% effective tax rate on dividends received by a corporation from another. The aggregate tax burden on the income which generated the earnings and profits which made the dividend possible is 49.726%. If amounts are subsequently distributed by the recipient corporation to an individual shareholder in the 50% bracket, the overall tax burden would be 75.362%. Incidentally, these percentages reflect the fact that the dividends received deduction claimed by the recipient corporation does not reduce its earnings and profits which support dividend treatment on its distributions.

It is evident from this brief review that the dividends received deduction ensures that substantial additional levels of tax are not imposed solely because of intervening tiers of corporations. The SIA believes that any legislation aimed at perceived areas of abuse should be specifically targeted so that the dividends received deduction continues to fulfill its originally enacted purpose.

The SIA has consulted with the Treasury and responsible Congressional staff from the time the Senate Finance Committee staff first published its Subchapter C report, and we are pleased that in general the Treasury has been responsive to our concerns. For example, the Treasury proposal to extend the required holding period is limited to extraorindarily large dividends. The SIA believes, however, that the Administration's proposals require certain additional modifications, most notably with regard to the deduction of interest by a corporate shareholder and the computation of holding periods, to avoid an effective repeal of the dividends received deductions. These and other suggestions are discussed in greater detail below.

The SIA believes that the current 16-day required holding period (91 days in the case of certain preference dividends) is sufficient to ensure that corporations receiving the dividends received deduction are at risk for a sufficient period of time with respect to the underlying stock to prevent planning for so-called tax arbitrage, and that the few instances of extremely large dividends, e.g., the dividend on Chrysler preferred, receive notoriety out of all proportion to their frequency. Nevertheless, the SIA supports the Administration's proposals to require a greater than one year holding period for extraordinary dividends.

The explanation of the Administration's proposals prepared by the Staff of the Joint Committee on Taxation indicates that an extraordinary dividend would include dividends received within any 90-day period with a fair market value equal to or greater than 10 percent (5 percent in the case of preferred stock) of the taxpayer's basis in the stock, or dividends received within any one-year period with a fair market value equal to or greater than 20 percent of the taxpayer's basis in the stock (common or preferred). The SIA considers these percentages to be reasonable. We question, however, the need for the 20% annual limit which will raise many technical questions of measurement without providing any substantial protection to the Treasury. In addition, the SIA believes that the percentages should be applied to the fair market value of the stock just prior to its going ex-dividend rather than to the taxpayer's basis in the stock. The determination of whether a dividend is sufficiently large to enable manipulation of the dividend received deduction and, therefore, to require a longer holding period should be made without regard to the taxpayer's basis in the stock. In addition, enforcement of this provision by the Internal Revenue Service will be facilitated if the determination is made with respect to the particular dividend generally, rather than having different determinations being made with respect to different holders of the stock. In any event, taxpayers whose basis in the stock is significantly lower than the fair market value of the stock have successfully been at risk in the stock.

The Administration's proposal provides that the required holding period for dividend paying stock for a taxpayer to receive the dividend received deduction would exclude any period during which the taxpayer is a grantor of an in-the-money option with respect to the stock, or any period that the taxpayer's risk of loss is substantially diminished because of holding other positions. The SIA strongly opposes this modification of the rules currently provided in Section 246(c)(3) of the Internal Revenue Code which halts the accrual of holding period for any period during which the taxpayer is essentially in a short position with respect to property that is substantially identical to the dividend yielding stock. Quite frankly, we believe that the use of concepts from the straddle area is totally inappropriate in the case of the dividends received deduction. The "offsetting position" concept of Section 1092 was developed to deal with deferral of income and conversion of income. Such transactions are rightly subject to tough standards. The purpose of the dividends received deduction is to prevent previously taxed income from being taxed again. Thus the purpose of a holding period requirement in the dividends received area is simply to assure that the person claiming the deduction is in fact the owner of the underlying stock required to include the dividend in income. Since only one dividend received deduction may properly be claimed with respect to a dividend, it is difficult to understand the concern of the Treasury about the "substantially identical" standard of current law.

Furthermore, the SIA believes that the "substantially diminished" risk of loss is too vague a standard to be adopted without causing severe dislocations and disruptions in the equity markets because of its uncertainty of application without any concomitant to tax policy benefit. For example, would a taxpayer which is short one utility stock and long the stock of another utility be considered to have substantially diminished its risk of loss? To some extent, any time a taxpayer does not put all his eggs into one basket it may be said to have diminished its risk of loss, and the adoption of such a standard would have a chilling effect on many commercial transactions.

The SIA also believes that not permitting the accrual of holding period during any period for which the taxpayer is a grantor of an in-the-money option without regard to whether the option is deep-in-the-money is too harsh a standard. Taxpayers write covered call options for reasons unrelated to tax avoidance, and these options are sometimes slightly in-the-money. For example, for a stock trading at $43 per share, there might be call options with strike prices of $30, $35, $40, $45, and $50. A taxpayer engaged in a covered call writing program would probably write the option at either $40.00 or at $45.00. The slight in-the-money feature present with respect to the $40 option is insufficient, because of the customary fluctuations in the market price of the stock, to treat the taxpayer as being in a short position with respect to the stock by virtue of having written the option. Accordingly, the SIA believes that any treatment of an in-the-money option as being equivalent to a short sale for purposes of non-accrual of holding period under Section 246(c), should be limited to deep-in-the-money options. This would follow the position adopted by the Senate Finance Committee with respect to S. 2062 to not treat covered non-deep-in-money options as being straddles subject to the loss deferral rules of section 1092. In general, however, the SIA believes that the substantially identical rule of Section 246(c) continues to provide adequate protection against taxpayers accruing holding period without being at risk in the stock. Indeed a strong argument can be made for even a looser standard.

The SIA supports the Administration's proposal with respect to the non-deductibility and capitalization of payments in lieu of dividends in cases where the short sale is not held open for at least sixteen days, or at least one year and a day in the case of payments in lieu of extra-ordinary dividends. The SIA believes that this would appropriately complement the rules with respect to the required holding period for the dividends received deduction.

The SIA has the greatest concern about the Administration's proposals to limit the deduction for interest paid or accrued on debt which but for an investment in stock would not have been incurred. The Treasury Department's General Explanation states that the amount of the disallowance would be an amount equal to the dividends received deduction claimed with respect to the dividends received on the leveraged stock. Although the mere simultaneous existence of a corporate line of credit and the holding of portfolio stock is said by the Treasury not to give rise to an interest deduction disallowance under the proposal, purchases through margin accounts and other cases in which borrowings are incurred to finance investment positions would be within the disallowance provision.

The uncertain scope of the Treasury proposal gives the SIA great concern. The "but for" language could easily be interpreted to require a disallowance at any time that a taxpayer could have sold some of its portfolio stock rather than borrowing. The effect of such an interpretation will be to substantially repeal the dividend received deduction which, as discussed above, is necessary to ensure that corporate earnings are taxed at only one level. The proposals will effectively treat high dividend paying stocks, e.g., preferred, as being equivalent to a junior subordinated debt and will affect the ability of corporations to finance and raise equity through issuance of such stock. This could have severe adverse effect on such issuers as utilities and banks which use preferred stock as an attractive alternative to issuing debt because issuance of such stock improves their debt equity ratio and enables them to raise capital at a reasonable cost. In addition, corporations in many cyclical industries have been recent issuers of preferred stock as a method of avoiding dilution of their common stock, and to maintain current credit ratings to minimize borrowing costs. The denial of interest deductions will affect all these corporations' ability to raise equity capital through issuance of preferred stocks.

The Administration's proposal would apply to leveraged stock investments entered into after the date of enactment. There appears to be no "grandfather" provision for stocks currently outstanding in the hands of new investors. As of September 30, 1983, there were 881 issues of preferred stock with market value of $45 billion listed on the New York and American Stock Exchanges. Studies have shown that the enactment of this proposal would result in an immediate decline in the value of outstanding preferred stocks ranging in the billions of dollars because of the higher yield that would be required to make these stocks attractive investments if the dividend received deduction is effectively repealed. This is far in excess of any potential revenue gain to the Treasury.

It is worth noting that Congress has generally disallowed a deduction for interest paid or incurred to carry tax advantaged investments only in instances where there is an essentially risk free tax arbitrage between the interest paid on the one hand and a secure return on the other hand. For example, Section 265 of the Internal Revenue Code disallows deductions for interest which is paid or incurred to carry tax exempt obligations because there is ordinarily little risk as to either the principal or interest payments due on tax exempt obligations with the result that there would be a clear arbitrage opportunity if the interest which is paid or incurred to carry such obligations were deductible. Similarly, Section 263(g) of the Internal Revenue Code disallows a current deduction for interest and carrying charges properly allocable to personal property which is part of a straddle because the taxpayer has locked in the future price for the personal property and the future price reflects the interest and carrying charges with respect to the personal property. Accordingly, in the absence of Section 263(g), the taxpayer would have a clear arbitrage possibility because the taxpayer is assured of being able to sell the personal property at a price which will recompense him for the interest and carrying charges. By contrast, a taxpayer who borrows money in a full recourse transaction to purchase dividend yielding stock will ordinarily be at risk both with respect to the ultimate price receivable upon the sale of that stock and as to whether the dividends will be paid on a timely basis and, therefore, the risk free arbitrage possibilities are not present in this situation. A limited exception to this might be present in the case of certain preferred stocks acquired with non-recourse debt and it might be appropriate to narrowly target legislation at this type of transaction.

If such legislation is enacted despite our concerns, the statute drafted or the Committee's report should make it clear that the interest disallowance should apply, as stated in the Treasury General Explanation, only to portfolio investments. Positions held by a dealer in securities should not be subject to the rule since the purpose of debt incurred by a dealer is to finance the inventory held for sale to customers in the ordinary course of its trade or business. No other industry is required to capitalize interest expense incurred to finance its inventory, and it would be unjust to impose this burden on our industry because it happens to sell stock rather than widgets.

MARKET DISCOUNT

The Treasury Department is proposing that gain recognized on the sale or retirement of a bond be treated as interest to the extent of accrued market discount for all bonds issued after the date of enactment. Gain in excess of accrued market discount would continue to be treated as capital gain. Inconsistently, the Treasury is proposing no changes to the treatment of losses.

The SIA completely disagrees with the premise of this proposal, namely that the amount of market discount is in all respects the economic equivalent of interest to the holder of a bond. The price of a corporate bond originally issued at par can fall for a number of reasons other than fluctuations in interest rates. A change in the market's perception of the relative creditworthiness of the issuer is the most obvious situation where the price of a bond can fall generating market discount.

Furthermore, status of an amount of income as interest rather than capital gain has a wide array of implications for many different purposes of the Code. The Treasury proposal gives no indication of how these issues are to be addressed. Does the corporate issuer obtain the benefit of a deduction for the interest reported by the holder of the bond? Does the corporate issuer remain responsible for the reporting and back-up withholding required by the Interest and Dividend Compliance Act? Is the Treasury proposal intended to override the tax treaties which the United States is a party to which in some instances exempt gain from U.S. taxation but do not reduce the withholding rate to zero on interest? Does the logic of the Treasury proposal imply that market discount on municipal obligations will be treated as interest exempt under Section 103? Are the source of income rules applicable to interest to apply rather than the rules applicable to gain? Is the accrued market discount to be treated as interest for purposes of the partial exclusion of interest available in taxable years after December 31, 1984?

These issues I suggest are not just technical concerns of a tax lawyer. They have subtle and possibly disruptive effects on the securities markets which should be considered deliberately and carefully before any action is taken.

Let me close by saying that the SIA pledges itself to work with the Treasury and the staff on these important issues as this Committee continues with its work.

Mr. GIBBONS. And Ms. Ruth, let me assure you that, while I have assured everyone that this committee is not anti-Puerto Rican, we are not antiladies, either. We did not mean to put you last. You can blame that on the staff. [Laughter.]

We will take you next, with appropriate apologies.

STATEMENT OF HEATHER L. RUTH, EXECUTIVE DIRECTOR, PUBLIC SECURITIES ASSOCIATION

Ms. RUTH. Thank you, Mr. Chairman.

My feelings are not remotely hurt. In fact——

Mr. GIBBONS. Could you get real close to that microphone. We are going to have to get the committee to try to buy some from the Japanese next and see if we can get a little better sound equipment. [Laughter.]

Ms. RUTH. Mr. Chairman and members of this committee: My name is Heather L. Ruth. I am executive director of the Public Securities Association. Thank you for the opportunity to present the views of PSA on three of the proposals before you.

PSA is the national trade association of banks, dealers, and brokers that underwrite, trade, and sell State and local government securities, U.S. Government and Federal agency securities, and mortgage-backed securities. All 37 primary dealers in U.S. Government securities, those recognized by the Federal Reserve Bank of New York, as well as most other large Government dealers, are PSA members. Our total membership of almost 300 firms also accounts for 95 percent of the Nation's underwriting and trading of municipal securities.

We recognize the importance of efforts to reduce the size of the Federal deficit and to address technical inconsistencies in the Internal Revenue Code. However, we are concerned that some of the particular proposals under consideration here may reduce the efficiency and liquidity of sectors of the Nation's capital markets. This would tend to increase the cost of borrowing by the Federal Government, as well as by the States and localities.

You are considering tax changes which could significantly alter the incentives under which dealers and investors participate in one of the largest fixed income markets in the world. By the end of 1983, the Government, mortgage-backed and municipal markets collectively accounted for almost $1.8 trillion in outstanding securities, almost a trillion of which is privately held Federal debt.

Increasing the Federal cost of borrowing could offset Federal revenues and diminish the net new revenue impact of these proposals. My comments will focus on our analysis of the possible market impact of the three securities-related proposals. Our analysis is incomplete because the proposals in question are not yet available in proposed statutory language. Indeed, one of them is currently presented in the form of alternatives and, parenthetically, we are fully in support of Mr. Delaney's comments in that respect.

But first let me talk about market discount bonds, the Treasury proposal. The Treasury has proposed treating as ordinary income rather than capital gains that portion of appreciation on redemption or sale of bonds attributable to the acquisition in the secondary market at a discount.

A preliminary survey of our dealer community detects reasonable support for the administration's concept so long as it applies only to bonds issued after enactment. We are considerably less sanguine about any net gain accruing to the Treasury as a result of these proposed changes. Taxable debt instruments will become marginally less attractive than other investments for which full market appreciation is permitted capital gains treatment.

Additionally, the administrative effort to maintain records and make necessary calculations will tend to increase dealer spread. The possibility that these increased costs might exceed the rather modest new revenues, estimated at only $500,000 per year by Treasury, seems quite likely.

Furthermore, we are puzzled by Treasury's silence as to its intended treatment of losses. If gains derived from market discount are to be treated as ordinary income, logic requires that losses be treated similarly. We strongly urge symmetrical tax treatment of gains and losses.

Second, permissible interest expense deductions in transactions involving Treasury bills, the Joint Committee on Taxation staff proposal. At least two staff alternatives are presented in the pamphlet of February 17. One of these proposals is closely parallel to legislation introduced last week by Senator Moynihan. The proposals seek to eliminate the ability of investors to defer tax liability, as through the mismatch of interest income and expense deductions on short-term Treasury securities.

It is extremely difficult to comment on these proposals due to their recent public release, their alternative forms, and the lack of comment by the Treasury. However, we fear that adoption of any of these proposals may adversely affect the depth and breadth of the short-term Government securities market. This would materially affect Treasury's cost of borrowing because either proposal removes an existing incentive to invest in Treasury bills at current rates.

We urge Congress to be deliberate in considering these alternatives. The Office of Debt Management of the Treasury and the Federal Reserve should be consulted. Regardless, any new tax treatment must not affect current investors.

Third, zero coupon and original issue discount municipal securities, the Joint Committee on Taxation staff proposal. This proposal would treat municipal obligations in an equivalent manner to other debt obligations by requiring interest earned to be accrued under the so-called economic constant interest method.

PSA's municipal securities division does not oppose this concept so long as it would be applied only to obligations issued after enactment. Inequities can be avoided with a prospective effective date.

I could make one summary comment about the thrust of our recommendations as well. First, we urge the Congress to exercise great care in changing any of the basic structure of incentives operating on investors, especially when you are targeting investors in the Federal Government's own debt. Increased tax revenues must be weighed against potential increased Federal borrowing cost in the market.

In the case of the market discount bond proposal, we suspect that it may be a wash. In the case of the Treasury bill interest expense deduction proposals, we really don't have enough information to evaluate it, but we are very concerned about possible adverse effect.

Second, whatever changes in the rules you enact, please make them prospective, affecting only those securities issued after enactment. Changes of that type do have a disadvantage of creating a two-tier market for some period, a market condition which we would generally like to avoid. But even a two-tier market is better than the alternative of changing the tax treatment and therefore the market for the current holder of public securities, whether that holder be a dealer or an investor.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF HEATHER L. RUTH, EXECUTIVE DIRECTOR, PUBLIC SECURITIES ASSOCIATION

This statement of the Public Securities Association addreses the potential effect of three proposed changes in the taxation of debt obligations acquired at a discount on the public fixed income securities markets: The Administration's proposal regarding market discount on bonds and the proposals of the staff of the Joint Committee on Taxation regarding zero coupon and original issue discount municipal securities as well as their proposal concerning Treasury bills (i.e. U.S. Government obligations which are issued at a discount and payable without interest at a fixed maturity not exceeding one year). These tax amendments are being considered as part of Congressional efforts to eliminate certain tax-motivated securities transactions.

INTRODUCTION

PSA is the national trade association of banks, dealers and brokers that underwrite, trade and sell state and local government securities, U.S. government and federal agency securities and mortgage-backed securities. Our membership accounts for 95% of the nation's underwriting and trading of municipal securities. In addition, all thirty seven primary dealers in U.S. government securities, as recognized by the Federal Reserve Bank of New York, are PSA members.

We recognize the importance of efforts to reduce the size of the Federal deficit and the need to address technical inconsistencies in various provisions of the Internal Revenue Code. However, we are concerned that some of these particular proposals—at least as currently presented—may reduce the efficiency and liquidity of certain sectors of the nation's capital markets, thereby tending to increase the cost of borrowing by the Federal government, as well as by states and localities. Any increase in the Federal government's cost of borrwoing would offset Federal revenues and thereby diminish the net revenue generating impact of these proposals.

While the barest outline of these proposals has been public for some time, sufficient detail to permit review and analysis has been available only briefly. Quite significantly, these are not yet available in proposed statutory language. Therefore, our remarks will be limited to a preliminary analysis of the likely market implications of the proposals. At this time we will take a position only on the proposal regarding zero coupon and original issue discount municipal securities.

Under these circumstances, we urge the Committee and the Congress to be deliberate and careful in considering the potential consequences of these proposals. Such an approach is especially warrented because the changes under consideration could fundamentally alter the incentives under which dealers and investors participate in the capital markets. The following brief overview of the markets, and the role of the dealers and dealer banks in those markets, will provide useful background for the discussion which follows.

OVERVIEW OF THE MARKET

The municipal, mortgage-backed and government securities markets are among the largest fixed income markets in the world. At the end of 1983, they collectively accounted for about $1.8 trillion in outstanding securities. As of the end of 1982, there was over $845 billion of outstanding privately held federal debt, $177 billion in mortgage-backed securities and $422 billion in outstanding municipal debt. These markets operate as over-the-counter markets, where dealers and investors buy and sell securities by telephone. The importance of these markets may not only be measured by their size and range of participants, but also by their social utility: that is, the broad access they provide all levels of government to raise funds in the public capital markets at reasonable rates in a quick and orderly fashion.

In the government securities market, the Treasury issued new debt totalling $152 billion in 1982 and $188 billion in 1983. In addition to new issues, portions of the outstanding debt are refinanced by the Treasury each year. Average daily transactions amounted to approximately $32 billion at the end of 1982. Present estimates indicate that average trading volume is now in the range of about $43 billion.

The outstanding volume of Federal debt financed with short term instruments, Treasury bills, has grown significantly. In 1978, $161 billion in such securities was outstanding. By 1982 that figure had reached $312 billion and last year over $350 billion in Treasury bills were outstanding. At the end of 1983 daily trading activity in these securities averaged approximately $24 billion.

In 1983, a record $89 billion of mortgage-backed securities were issued. Trading activity continued to increase, with estimates indicating that more than $200 billion in mortgage-backed securities were traded last year.

The market for state and local government obligations is also very large and active. In 1983 the new issue market for long-term municipal securities reached a record $85 billion. It is not unusual for the largest dealers in this market to execute over 2,000 transactions a day.

THE ROLE OF THE DEALER

The major function of the municipal, government and mortgage-backed securities dealer, whether a sole municipal, mortgage-backed or government firm, is to create a market in those securities. This service is typically performed by a dealer's participation in the distribution of new issues of securities and through its participation in the secondary market as a "market maker." A market maker may be described as a dealer who is known to stand ready, under virtually any circumstances, to purchase or sell securities of a given issuer offered in the marketplace.

As a buyer of fixed-income securities (either as underwriter in the municipal market, distributor in the government or mortgage-backed markets, or as a secondary market maker with respect to any of the above), the dealer assumes the economic risk inherent in holding a security for which the future selling price is uncertain. the principal risk in these securities is not the credit of the issuer, as they are generally governmental entities. Rather, it is a market risk, which is a function of fluctuations in interest rates and the resulting price variation that may occur while these instruments are held. Interest rate fluctuations are of critical importance to the dealer for an additional reason because, to a large extent, his purchases of securities are financed with borrowed funds.

Dealers generally do not charge a commission for the transactions they perform for their large customers. Their profit is earned by selling securities for a price (ask) in excess of the price they paid (bid) for those same securities. This price difference is known as the "spread."

The relatively narrow spreads which usually prevail between the bid and ask price on municipal, mortgage-backed and government securities is one indication of overall market efficiency. More specifically, narrowness in the bid/ask spreads indicates an active, liquid market which is operating with a high degree of transactional efficiency.

Spreads tend to increase, sometimes dramatically, when market participants are faced with uncertainty. The prospect of abrupt and/or retroactive changes in tax law governing the fixed income markets may well constitute sufficient uncertainty to affect spreads.

WEIGHING INCREASED REVENUES AGAINST INCREASED GOVERNMENT BORROWING COSTS

We have explained the potential effect of uncertainty on interest rates by its effect on the dealer spread. Yet the maximum conceivable contribution of increased spread to the interest cost of governmental borrowing, would be modest as compared with the impact of more fundamental determinants of interest rates, such as underlying investor demand. Tax changes which decrease the attractiveness of securities—however marginally—tend to decrease demand by diminishing the level of market participation at current rates and/or bidding rates upward. Generally, assessing the net revenue impact of tax changes, such as those considered here, entails weighing any anticipated increased costs of borrowing against the increased revenues brought about by such change.

TREASURY DEPARTMENT PROPOSAL CONCERNING MARKET DISCOUNT ON BONDS

The Administration is proposing an important change in the taxation of market discount on bonds. Market discount arises when a bond decreases in value subsequent to its issuance, typically because of an increase in interest rates. For the purchaser of the security in the secondary market, the market discount equals the difference between the purchase price of the bond in the secondary market and the amount anticipated at maturity. The Administration proposal would tax gains derived from redemption or sale of market discount bonds as ordinary interest income to the holder of the bond, rather than as a capital gain. It has been estimated by the Treasury Department that the proposal will increase Federal revenue by less than $0.5 million per year in fiscal years 1985 through 1987.

The rationale for the proposal is to prevent the use of market discount bonds to achieve a conversion of ordinary income to capital gain by investors borowing to purchase market discount securities. Some would argue further that the proposed tax change would enhance the rationality and predictability of the markets. However, as currently presented, this proposal contains certain structural inconsistencies and raises the prospect of adding considerable administrative and operational burdens to the dealer community.

For example, the Administration would tax gains on market discount as interest income but is silent as to the treatment of losses. Are we to assume that such losses would continue to be treated as capital losses? If market discount is to be deemed equivalent to interest income, then logic would require that losses on market discount also be treated as ordinary losses for income tax purposes. Based on the language presented to date, at best we do not know the Administration's intent; at worst we fear an asymmetrical treatment of gains and losses. As noted in Treasury Department testimony, the holder of bonds acquired at a premium under present law is permitted to amortize the bond premium over its remaining life.

Further, the additional administrative effort of maintaining records and making the necessary calculations to allocate between ordinary versus capital gain or loss will require time to implement and the burden will tend to increase dealer spread.

As proposed, the amendment would be applied to bonds issued subsequent to the date of enactment. Such a transition rule can be expected to create a two-tiered market for discount bonds by creating a marginal disincentive to purchase market discount bonds subject to the new provisions and a corresponding marginal incentive to purchase bonds subject to the current provisions. In turn, this should produce somewhat greater liquidity on the "older" bonds and somewhat less liquidity on the "newer" bonds, potentially adding upward pressure on interest rates for newly issued bonds. Finally, these proposed changes may make debt instruments whose interest is taxable marginally less attractive to investors than other investments for which full market appreciation is permitted capital gains treatment.

A preliminary survey of the dealer community detects reasonable support for the Administration's proposal, so long as the new treatment applies only to bonds issued after enactment. However, the dealers also expressed considerable skepticism about any net gain accruing to the Treasury.

STAFF PROPOSAL OF JOINT COMMITTEE ON TAXATION REGARDING PERMISSIBLE INTEREST EXPENSE DEDUCTIONS IN TRANSACTIONS INVOLVING TREASURY BILLS

On February 17, 1984, the staff of the Joint Committee on Taxation released a pamphlet on tax shelters and other tax-motivated transactions. Among the many suggestions offered by the staff is one to change the permissible interest expense deduction in transactions involving Treasury bills. On February 22, 1984 Senator Daniel P. Moynihan introduced a similar proposal, as part of S. 2319, the Tax Shelter Reform Act of 1984. These proposals seek to eliminate the ability to defer tax liability, as through the mismatch of interest income and expense deductions on short term Treasury securities.

The staff pamphlet contains at least two alternative methods to address this issue:

(1) delaying the deductibility of interest incurred to purchase or carry Treasury bills until interest on the bills is includable in taxable income; and

(2) requiring taxpayers to accrue discount on Treasury bills regardless of the accounting method used by the taxpayer and regardless of whether the instruments are debt financed.

We are concerned that adoption of either of these proposals may adversely affect the depth and breadth of the short-term government securities market and materially affect Treasury's cost of borrowing. This result is anticipated because either proposal removes an existing incentive to invest in the short-term government securities market at current rates.

It should be noted that dealers commonly borrow funds to finance their inventory of short-term government securities. This serves the Treasury by contributing positively to the liquidity of the market and the narrowness of spreads.

Due to the potential increase in borrowing costs that could result from these proposals, we strongly suggest that each of the alternatives be studied very carefully. We also suggest that the office of Debt Management of the Treasury Department and the Federal Reserve be consulted as we are unaware of any position either has taken regarding this issue to date.

Whatever the Congress decides with respect to these proposed changes, we believes that the new rule should not effect current holders of Treasury bills. Due to the short term nature of the obligations and the inherent unfairness of retroactively changing their tax treatment, we suggest that any such legislation become effective only for Treasury bills issued after date of enactment, or as of a prospective date.

STAFF PROPOSAL OF JOINT COMMITTEE ON TAXATION REGARDING ZERO COUPON AND ORIGINAL ISSUE DISCOUNT MUNICIPAL SECURITIES

The staff of the Joint Committee on Taxation has also proposed that interest earned on zero coupon and original issue discount (OID) municipal securities be accrued under "the economic constant interest method." Current law permits holders of such municipal bonds to apportion interest ratably over the term of the obligation. This proposal would treat municipal obligations in an equivalent manner to other debt obligations. The Municipal Securities Division Executive Committee does not oppose this concept, so long as it would be applied only to obligations issued after enactment.

Thus, our principal concern is the implied retroactive effective date and the lack of adequate transition rules. It would be inequitable to change the tax rules for present holders of zero coupon and OID municipal securities. Further, the marketability of securities currently outstanding will be diminished if such protection to current holders of these securities is not extended to subsequent holders. Application of a new provision only to securities issued after enactment would tend to create a two-tiered market. In our view, however, that is more appropriate than any other alternative.

Mr. GIBBONS. Thank you.

Do my colleagues have questions for this panel?

[No response.]

Mr. GIBBONS. I want to say to the panel that, particularly the American Bar Association Taxation Section, your criticism of us is valid. I do not like the process. I wish we could find a better way to do it. We will be looking forward to hearing from all of you on how we can improve the process as well as the quality of our legislation.

We are in a difficult time with difficult problems, and I guess that is always true for anybody sitting in these seats, no matter what the time is. But we appreciate your coming. I want you to know I will be reading your statements and going over them.

Mr. DELANEY. Thank you, Mr. Chairman.

Let me say, the Tax Section is spending a good deal of time trying to design a better technique for adopting and enacting tax legislation, and of course we stand ready at all times to work with your staff and the joint committee staff on these specific problems.

Thank you.

Mr. GIBBONS. Before you leave, what I would like to do is, sometimes I would like to draft what is perhaps a far more simplified tax system than we have now and then give everybody that is involved in the process about 10 years to adjust to that system.

I do not know any way out of the quagmire we are in right now. If we pass this statute here, the Commerce Clearing House, Prentice Hall and the other publishers are going to have a field day with it. Probably the tax deductible time that you spend trying to figure out what we have done may offset any revenue it might generate. [Laughter.]

But that is where we are.

Mr. DELANEY. Well, that is true, Mr. Congressman. But it is a fact that we do have an extremely complex economy, and I doubt that you are ever going to get to the simplest type of tax.

Mr. GIBBONS. I realize that. You can never finish washing your face, is the problem and we will always be tinkering around with washing our face in this operation. But this is not a good way to proceed as we are going at it now.

We appreciate your coming.

The next panel: Alicia Munnell; our old friend Daniel Halperin; Mr. Charles Rogers; Ms. Susan Koralik, Mr. Lloyd Kaye; and Robert Peters.

We will start with the Federal Reserve Bank of Boston. Go right ahead, Ms. Munnell. And please get close to these old microphones.

STATEMENT OF ALICIA H. MUNNELL, VICE PRESIDENT AND ECONOMIST, FEDERAL RESERVE BANK OF BOSTON

Ms. MUNNELL. Good morning. My name is Alicia H. Munnell. I am an economist and vice president of the Federal Reserve Bank of Boston. The remarks I have this morning represent my own opinion and not that of the Federal Reserve Bank of Boston or the Federal Reserve System.

I have a prepared statement which I would like to submit for the record and I will make my comments very brief.

Mr. GIBBONS. Everyone's statements will appear in the record. Go ahead.

Ms. MUNNELL. What I would like to do this morning is discuss the issue of cafeteria plans within the context of the growth of employee benefits. As you know, employee benefits have increased from about 2 percent of total employee compensation in 1950 to 10 percent in 1983. This growth has had disastrous effect on both the payroll tax base and the income tax base.

Although the revenue loss due to the erosion of the income tax base is readily acknowledged, it is generally assumed that the social security system does not suffer when its base is eroded because a reduction in current taxes leads to a reduction in future benefits. New cost calculations, however, have showed that the long-run costs to social security are sensitive to changes in the payroll tax base. In addition, an immediate loss of revenues occurs as a result of this favorable treatment of employee benefits. Thus, significant revenue effects are associated with the growth of fringe benefits and the consequent erosion of both the income and payroll tax bases.

Given the enormous revenue loss, the question is what will be the trend in the ratio of employee benefits to total compensation over time. A study of the origin and development of employee benefit plans indicates that this ratio is likely to increase, as costs soar and innovative benefits are introduced.

In the area of traditional employee benefits, the growth probably will not be due to an expansion of coverage, since in the medium and large-sized firms coverage is almost universal for pensions, group health and group life insurance. However, expenditures for these benefits will increase somewhat as a result of benefit improvements, primarily in the area of private pension plans, and increasing costs in the area of group health insurance.

In addition to the growth in traditional benefits, there has been a vast array of new benefits introduced over the last 10 years, including ESOP's, and such employer-provided benefits as educational assistance, prepaid legal services, and van pooling. Cafeteria plans were introduced in 1978 along with 401(k)'s, and 1980 legislation allowed 401(k)'s to be included in cafeteria plans.

The uncontrolled growth of these plans is going to have a very deleterious effect on the payroll and income tax base. Thus, we must determine whether we want to continue to have these bases eroded by the expansion of employee benefits or whether it is desirable to control future growth. Since there is a pressing need for revenues in this country, the only feasible alternative seems to be reform.

The ideal reform, of course, would be to include all employee benefits under both the payroll and income tax. However, since this is probably not politically feasible, the main area that we should look at is the growth of new benefits.

In the area of cafeteria plans the options include repealing section 125 so that the principle of constructive receipt is reintroduced, or severely limiting the benefit options that can be offered within a cafeteria plan. Given a choice, I would limit the options in a cafeteria plan to group health and group life insurance and pensions and eliminate educational assistance, dependent care assistance, and the like.

Another consideration that is very important when thinking about what to do in the area of employee benefits is whether to treat the payroll tax and the income tax symmetrically. Some pragmatic arguments can be made for making most employee benefits subject to the FICA tax immediately and then addressing income tax reform on a benefit by benefit basis.

The arguments against proceeding on a benefit by benefit basis, however, are more substantial. Nowhere is that more visible than in the new or growing interest in voluntary employee benefit accounts arising in the wake of the restrictions placed upon pension plans under TEFRA.

In conclusion, my overall proposal would be to establish an overall aggregate limit on the amount of employee benefits that people can receive tax free. That limit should probably be progressive in some sense. For example, people could have tax free benefits equal to 25 percent of total compensation for the first $40,000 of income, 15 percent for the next $40,000, and 5 percent after that. I think an aggregate limit on the amount of employee benefits that can be excluded from taxable income is probably the most effective way to limit the erosion of the payroll and income tax base.

Thank you.

[The prepared statement follows:]

STATEMENT OF ALICIA H. MUNNELL,[1] VICE PRESIDENT AND ECONOMIST, FEDERAL RESERVE BANK OF BOSTON

The Erosion of the Tax Base by Employee Benefits

The Administration's 1985 Budget contains two proposals—the taxation of employer-paid health insurance premiums and the placement of restrictions on cafeteria plans—that are aimed at reducing the revenue loss caused by the expansion of nontaxable employer-provided fringe benefits. These proposals have the desirable effect of focusing attention on a major development that is seriously eroding not only the personal income tax, but also the payroll tax base. My remarks this afternoon will attempt to quantify the impact of this development on both the income and payroll tax bases, examine the outlook for employee benefits in view of the increasing popularity of 401(k) and cafeteria plans, and offer some possible options for reform.

I. THE GROWTH OF EMPLOYEE BENEFITS AND ITS IMPACT ON THE TAX BASE

Between 1950 and 1983, employee benefits have increased from 12.6 to 28.5 percent of total compensation (see Table 1). Part of the expansion has had no impact on taxable income, however, since compensation for "time not worked" in the form of rest periods, holidays and vacations is paid in wages, which are included in full in both the income and payroll tax base. The growth of some other fringe benefits, which are not included in taxable income, has been beyond the control of individual employers, since it reflects the increased contributions required for legally mandated programs, such as social security and unemployment compensation.

TABLE 1.—GROWTH OF EMPLOYEE BENEFITS, 1950–83

[Dollars in billions]

Compensation	1950	1960	1970	1980	1983[1]
Total compensation	$154.8	$294.9	$612.0	$1,599.6	$1,991.6
Wages and salaries	$147.0	$271.9	$548.7	$1,356.6	$1,663.9
For time worked	$135.2	$243.9	$482.9	$1,169.4	$1,424.9
For time not worked[2]	$11.8	$28.0	$65.8	$187.2	$239.0
Nonwage compensation	$7.8	$23.0	$63.3	$243.0	$327.7
	(As percent of total compensation)				
Nonwage compensation	5.0	7.8	10.3	15.3	16.5
Legally required	2.4	3.6	4.4	6.4	6.7
OASDHI	.8	1.9	3.0	4.2	4.7
Unemployment compensation	1.0	1.0	.6	1.0	.9
Worker's compensation	.6	.7	.8	1.2	1.1
Agreed-Upon	2.6	4.4	6.0	8.9	9.8
Government pensions[3]	.7	1.2	1.3	1.8	1.8

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[1] The views expressed are solely those of the author and do not necessarily reflect the official position of the Federal Reserve Bank of Boston or the Federal Reserve System.

TABLE 1.—GROWTH OF EMPLOYEE BENEFITS, 1950–83—Continued

[Dollars in billions]

Compensation	1950	1960	1970	1980	1983[1]
Private pensions and profit sharing	1.1	1.6	2.1	3.5	3.7
Group health	.5	1.1	2.0	3.1	3.8
Group life	.2	.4	.5	.4	.4
Other	.1	.1	.1	.1	.1
Wages for time not worked	7.6	9.5	10.8	11.7	12.0
Total benefits	12.6	17.5	21.1	27.0	28.5

[1] Projections for total compensation and wages and salaries were obtained from Data Resources, Inc. Percentages were estimated by author assuming rate of growth from 1982–1983 was the same as that from 1980–82.

[2] Estimated by author using data from the Chamber of Commerce for 1951, 61, 71 and 81.

[3] Includes Federal Civilian Retirement System, Railroad Retirement System, and state and local retirement systems; military pensions are not included. In 1971, the Treasury Department began to transfer funds into the Federal Civilian Retirement System to pay the interest on unfunded liability and to amortize over a 30-year period any increase in the unfunded liability. Since these transfers are not included in the National Income and Product Accounts, we did not include them in this table in order to maintain consistency. This results, however, in an understatement of the contributions to government pensions relative to private pensions and profit sharing.

Sources: Chamber of Commerce of the United States, "Employee Benefits Historical Data, 1951–1979" (Washington, D.C., 1981) and "Employee Benefits 1981 (Washington, D.C., 1982); "The National Income and Product Accounts, 1929–76, Statistical Tables," Supplement to the "Survey of Current Business," vol. 61 (September 1981), Tables 1.11, 2.1, 6.15; "National Income and Product Accounts, 1976–79," Special Supplement to the "Survey of Current Business," vol. 61 (July 1981), Tables 1.11,, 2.1, 6.15; and "Survey of Current Business," vol. 63 (July 1983), Tables 1.11, 2.1, 6.15.

The main area of concern for tax policy and the major source of erosion of the tax base has been the growth of the so-called "agreed-upon" benefits—to date, primarily pensions, group health, and group life insurance—which allow employees either to avoid the payment of income and payroll tax altogether or to profit from the deferral of income tax payments until retirement.[2] Employer contributions to these plans have increased from 2.6 to 9.8 percent of total compensation between 1950 and 1983.

The impact of employee benefits on the income tax base

The effect of the exclusion of group health and life insurance on the income tax base and on personal income tax receipts is straightforward. Gross income is lowered by the amount of the contributions and taxes are reduced by an amount equal to the relevant marginal income tax rate times the excluded contributions. This reduction in receipts, commonly referred to as a "tax expenditure," is calculated annually by the Treasury Department and included as a Special Analysis to the Budget document.

The impact of the favorable tax treatment of pensions on the tax base and tax receipts is somewhat more complicated, since this employee benefit involves the deferral of taxation rather than complete avoidance.[3] For cash-based budget purposes, the revenue effect in a given year is the net of two offsetting parts—the revenue loss from exempting employer contributions and pension fund earnings from current taxation, and the revenue gain from currently taxing private pension benefits.

Calculations for 1983 indicate that the net revenue loss for the three primary statutgry benefits—group health and life insurance and pensions—amoulted to over $64 billion, which represents almost 22 percent of personal income tax receipts in that year (see Table 2). In other words, personal income tax revenues would have been almost 22 percent higher if employee benefits were taxed in the same manner as wage and salary income, or tax rates could have been reduced approximately 18 percent and still have provided the same revenue.

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[2] Under current law, compensation in the form of employer contributions to qualified pension and profit sharing plans are deductible by the employer when contributions are made, but are not taxed to the employee until benefits are distributed from the plan. In addition, interest on plan assets is allowed to accumulate tax free until it is distributed to the employee. All contributions made by employees to health and accident insurance plans are excluded from the employee's taxable income as well as employer premiums for up to $50,000 of group term life insurance. Other statutory exclusions include: (1) up to $5,000 of death benefits; (2) parsonage allowances; (3) certain benefits provided to members of the armed forces; (4) meals and lodging provided for the convenience of the employer; (5) group legal services; (6) expenses incurred by commuting through use of a van pool; (7) employee educational assistance; and (8) dependent care assistance. Nonstatutory exclusions include such items as tuition reductions, airline passes, subsidized cafeterias and others.

[3] See Appendix for evaluation of current estimates of revenue loss from the favorable tax treatment of qualified pension plans and an alternative method of calculating this figure.

TABLE 2.—REVENUE EFECTS [1] UNDER PERSONAL INCOME TAX FROM "AGREED-UPON" EMPLOYEE BENEFITS, 1950–83

[Dollars in billions]

Benefit	1950	1960	1970	1980	1983 [2]
Group health insurance: Exclusion of employer contributions	−$0.2	−$0.8	−$2.8	−$12.9	−$19.6
Group life insurance: Exclusion of employer contributions	−$.1	−$.2	−$.7	−$1.7	−$2.0
Pensions and profit sharing private plans:					
Exclusion of employer contributions	−$.4	−$1.1	−$2.8	−$14.1	−$18.6
Exclusion of fund earnings [3]	([4])	−$.4	−$2.3	−$13.5	−$17.3
Inclusion of current benefits	([4])	+$.2	+$.8	+$4.6	+$7.5
Net revenue effect	−$.4	−$1.3	−$4.3	−$23.0	−$28.4
Government plans:[5]					
Exclusion of employer contributions	−$.3	−$.7	−$1.8	−$7.3	−$9.3
Exclusion of fund earnings [3]	([4])	−$.2	−$1.3	−$8.3	−$11.3
Inclusion of current benefits	+$.1	+$.3	+$.9	+$4.1	+$5.8
Net revenue effect	−$.1	−$.6	−$2.2	−$11.7	−$14.8
Total revenue effect	−$.8	−$2.9	−$10.0	−$49.1	−$64.8
Addendum: Revenue loss as a percent of personal income tax receipts	4.0	6.9	11.3	19.7	21.8

[1] Revenue loss calculated by author using average marginal tax rates developed by Barro and Sahasakul—23 percent in 1950, 1960 and 1970 and 26 percent in 1980 and 1983. Revenue gain estimated assuming retirees face a marginal tax rate equal to one-half the average marginal rate.

[2] Contributions, assets and benefits projected by author assuming rate of growth from 1982–83 was the same as that from 1980–82.

[3] Fund earnings calculated by author using asset information from "Flow of Funds Accounts" and assuming a rate of return on those assets equal to the rate earned on 3-month Treasuries in that year.

[4] Less than $0.05 billion.

[5] Includes Federal Civilian Retirement System, Railroad Retirement System, and state and local retirement systems; the military retirement plan is not included.

Sources: Board of Governors of the Federal Reserve System, "Flow of Funds Accounts, 1949–1978: Annual Total Flows and Year-End Assets and Liabilities (1979) and Assets and Liabilities Outstanding, 1959–1982" (1983); "The National Income and Product Accounts, 1929–76 Statistical Tables," Supplement to the "Survey of Current Business," vol. 61 (September 1981), "National Income and Product Accounts, 1976–79," Special Supplement to the "Survey of Current Business," vol. 61 (July 1981), and "Survey of Current Business," vol. 63 (July 1983), Tables 1.11, 3.4, 6.15 and 8–4; Robert J. Barro and Chaipat Sahasakul, "Measuring the Average Marginal Tax Rate from the Individual Income Tax," NBER Working Paper No. 1060 (January 1983); Council of Economic Advisors, Economic "Report of the President" (Washington, D.C., 1983); American Council of Life Insurance "Pension Facts 1982" (Washington, D.C. 1983).

The impact of employee benefits on the payroll tax base

Exclusions from the payroll tax base have never been considered "tax expenditures," since the Treasury and the Congressional Budget Office assume that with social security payments tied to the level of contributions "any reduction in contributions is reflected in lower benefits." [4] In fact, while benefit payments are reduced somewhat by the decline in the payroll tax base that accompanies the expansion of nonwage compensation, the benefit reduction is less than the tax reduction. The reason for the lesser decline in benefits is the weighted benefit formula, which provides that a smaller percentage of wages are replaced at higher earnings levels than at lower ones.[5] Since a substantial portion of the decline in the payroll tax base, caused by the growth in employee benefits, occurs at higher earnings levels, benefit payments are not reduced significantly. Thus, the long-term costs of the program rise as the ratio of employee benefits to total compensation increases.

The magnitude of the cost increase has been calculated by comparing a system in which the ratio of employee benefits to total compensation continues to grow at historial rates with a system where the ratio remains constant.[6] The analysis reveals that if the ratio of finge benefits to total compensation stabilized at current levels, the projected payroll tax rate required to finance the retirement and disability portions of the social security program over the next 75 years could be reduced by roughly 0.5 percentage points. That is, instead of requiring revenues equal to 12.8 percent of taxable payrolls to cover promised benefits, the system could be financed for the next 75 years at an average cost of 12.3 percent.

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[4] Congressional Budget Office, "Tax Subsidies for Medical Care: Current Policies and Possible Alternatives" (GPO, 1980), p. 5.

[5] The effect of employee benefits on long-range costs was first discussed by Yung-Ping Chen, "The Growth of Fringe Benefits: Implications for Social Security," Monthly Labor Review (November 1981), pp. 3–10.

[6] The effect of the growth of employee benefits on long-range costs has been estimated by both Chen and the social security actuaries, each of whom compared a system where the ratio of benefits to compensation increased by 0.4 percent annually with a situation where the ratio remained constant. See Social Security Administration, Office of the Actuary, "Growth in Fringe Benefits," Actuarial Note No. 113 (June 1982).

Of course, it is also interesting to look at the immediate payroll tax revenue loss associated with employee benefits without considering the long-term effect on future social security benefit commitments. This calculation differs from that performed for the income tax in two respects. First, employer contributions for all employee benefits represent permanent reductions in the payroll tax base; even contributions to pension plans escape tax completely, since no payroll tax is levied on pension benefits in retirement. Second, revenue loss occurs on both the employees' and employers' side of the transaction, since neither party is required to pay taxes on exempt employer-provided benefits. The calculations indicate that 1983 payroll tax receipts would have been $21 billion higher if employee benefits were included in the tax base (see Table 3). Alternatively, the 1983 payroll tax rate for the retirement and disability portion of the program could have been lowered from 5.4 percent each for the employer and employee to 4.9 percent, without any reduction in 1983 revenues.

TABLE 3.—IMMEDIATE REVENUE EFFECTS UNDER THE PAYROLL TAX FROM "AGREED-UPON" EMPLOYEE BENEFITS, 1950–83

[Dollars in billions]

Benefits	1950	1960	1970	1980	1983 [1]
Group health insurance	([2])	−$0.2	−$0.9	−$5.4	[3] −$8.4
Group life insurance	([2])	−$.1	−$.2	−$.7	[3] −$.9
Pension and profit sharing:					
Private pensions	([2])	−$.2	−$1.0	−$5.9	−$7.9
Government pensions	([2])	−$.1	−$.6	−$3.1	−$4.0
Total revenue effect	−$0.1	−$.6	−$2.7	−$15.1	−$21.2
Addendum: Revenue loss as percent of payroll tax receipts	2.8	4.5	6.2	10.4	10.7

[1] Contributions projected by author (see Table 1, footnote a).

[2] Less than $0.05 billion.

[3] These estimates are somewhat higher than those prepared by the Joint Committee on Taxation in Table 1 of "Pamphlet Prepared by Joint Committee on Taxation on Administration Proposal to Tax Employer-Provided Medical Insurance, and Explanations of Tax Treatment of Benefits" (June 1983), reprinted in Bureau of National Affairs, BNA Pension Reporter (June 27, 1983).

Sources: Social Security Bulletin, Annual Statistical Supplement, 1983 (GPO, 1983), pp. 72, 200: 1983 Annual Report of the Board of Trustees of the Federal Old Age and Survivors Insurance and Disability Insurance Trust Funds (GPO, 1983); The National Income and Product Accounts, 1929–76 Statistical Tables, Supplement to the Survey of Current Business, vol. 61 (September 1981), National Income and Product Accounts, 1976–79, vol. 61 (July 1981), and Revised Estimates of National Income and Product Accounts, vol. 63 (July 1983), Table 8.4.

II. THE OUTLOOK FOR EMPLOYEE BENEFITS

In view of the enormous impact of nontaxable fringe benefits on both the payroll and income tax bases, it is obviously crucial to assess the future growth of this form of compensation. The social security trustee project that the ratio of benefits to total compensation will increase by 0.3 percent annually, so that by the year 2000 noncash compensation will account for 21 percent of the total. A decade ago such forecast might have been viewed as somewhat high, since the workforce appeared fairly well saturated with the traditional statutory benefits. Recent developments, however, reveal considerable interest on the part of both the employee and the employer in expanding the role of nontaxable compensation and a willingness on the part of Congress to provide new mechanical to accomplish this goal. In order to assess the reasonableness of the social security projection, let us first examine the outlook for the traditional statutory benefits and then turn to the likely development of the more recently enacted forms of benefit plans.

TRADITIONAL STATUTORY BENEFITS

Increases in employer contributions for the three primary statutory benefits—pensions, health insurance and life insurance—will come primarily from benefit improvements and increased costs rather than through expanded coverage.

Coverage for any of the three major benefits is unlikely to expand much further. The percentage of the civilian workforce covered by these plans has remained almost constant since 1970 and a recent study by the Bureau of Labor Statistics showed that coverage in medium and large firms, the main providers of employee benefits, was nearly universal—97 percent of employees in these firms had health insurance, 96 percent had life insurance and 84 percent had retirement pensions.[7] Moreover, the shifting industrial structure in the United States tends to make futher major increases in coverage unlikely. Industries with traditionally high benefit coverage, such as manufacturing, are expected to employ a declining share of workers, while employment in industries with low benefit coverage, such as retail trade and services, is projected to increase.

Some increase in employer contributions relative to compensation will probably be required, however, to finance benefit improvements, particularly in the area of private pension plans. With growing numbers of people approaching retirement dependent in part on the purchasing power of their private pension benefits, pressure will develop for some post-retirement cost-of-living adjustments. Without this form of protection, even modest annual price increases of 4 percent will cut the value of a pension in half after 15 years. Any rekindling of double digit inflation would, of course, have a much more dramatic impact. Although government pension plans have either partial or full indexation, virtually no employers in the private sector provide automatic cost-of-living adjustments after retirement. With persistent inflation, a trend toward earlier retirement, and increased longevity, some form of cost-of-living clauses to private pension benefits seem inevitable.

Employer contributions to traditional benefit plans are also likely to increase as a percent of total compensation because the cost of providing some benefits will probably continue to rise faster than wages. The development of sophisticated and expensive technologies make it almost inevitable that medical costs will increase at a more rapid pace than the general price level. In addition, pension costs can also be expected to increase (even without the adoption of cost-of-living provisions) as public sector sponsors move toward full funding of their plans.

In short, some increase in the ratio of benefits to compensaiton should be expected from benefit improvements and rising costs in the traditional employee benefit plans.

NEW TYPES OF BENEFITS

A major source of growth in nontaxable employer-provided benefits, however, will probably come from new types of plans. In the last ten years a host of tax-favored employee benefit provisions have been introduced and other benefits are in the process of moving from the realm of administrative ruling to statutory standing. Let us look first at the expansion in statutory benefits.

Expansion of statutory benefits

The major extension of statutory benefits began in 1974 with incentives for employers to establish employee stock ownership plans (ESOPs) for their employees (see Table 4). The tax advantages of ESOPs for both and employer are substantial. Contributions to the trusts are deductible by the employer, but not taxable to the employee until distributed. The trust is tax exempt so that earnings of the trust and dividends paid to the trust are allowed to accumulated tax free. On the employee's side, then, ESOPs share all the attractive deferral features of private penson plans. On the employer's side, the deductibiltiy of contributions allows the company to take a tax deduction for the repayment of principal as well as interest on loans made from the trust, an option not available in conventional financing.

TABLE 4.—EXPANSION OF STATUTORY EMPLOYEE BENEFITS, 1974 TO THE PRESENT

Year	Statutory benefit	Legislation	Provision [1]
1974–81 ...	ESOP's	Employee Retirement Income Security Act of 1974.	Singled out employee stock ownership plans (ESOPs) as only benefit plans that could be used as a vehicle for corporate borrowing, by exempting ESOPs from certain fiduciary standards regarding diversification and parties-in-interest transactions.
	......do	Tax Reduction Act of 1975.	Permitted corporations to take an additional 1 percent investment tax credit if the funds were invested in ESOPs.

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[7] U.S. Department of Labor, Bureau of Labor Statistics, "Employee Benefits in Medium and Large Firms, 1982," Bulletin 2176 (August 1983), table 1, p. 16.

TABLE 4.—EXPANSION OF STATUTORY EMPLOYEE BENEFITS, 1974 TO THE PRESENT—Continued

Year	Statutory benefit	Legislation	Provision [1]
	......do	Economic Recovery Tax Act of 1981.	Revised the investment tax credit associated with ESOPs so that the additional allowable credit is based on the lesser of either the total value of employer securities transferred to the ESOP or a prescribed percentage of annual compensation of all employees covered by the plan.[2] The credit expires on January 1, 1988.
1976	Legal services	Tax Reform Act of 1976	Allowed employees to exclude from gross income the value of employer contributions to qualified prepaid legal services plans, as well as the value of any legal services provided. Applicable to self-employed individuals. Expires January 1, 1985.
1978	Van pooling	Revenue Act of 1978	Allowed employees to exclude from gross income the value of employer provided transportation to and from work by commuter van. Not applicable to self-employed individuals. Expires January 1, 1986.
1978	Educational assistance.	......do	Allowed employees to exclude from gross income the value of employer provided educational assistance. Applicable to self-employed individuals. Expired January 1, 1984.
1978	Cafeteria plans	......do	Eliminated the doctrine of "constructive receipt." Allowed employees to exclude from taxable income the value of benefits chosen under a qualified cafeteria plan if the benefit would have been nontaxable in the absence of the plan.
1978–80	401(k) plans	......do	Allowed employees to reduce their salary by up to 15 percent of compensation and to invest money tax free in a deferred compensation account.
	......do	Miscellaneous Revenue Act of 1980.	Allowed 401(k) plans to be included in cafeteria plans.
1981	Dependent care assistance.	Economic Recovery Tax Act of 1981.	Allowed employees to exclude from gross income the value of employer-provided dependent care assistance.

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[1] In addition to these specific provisions, most statutory fringes must comply with nondiscrimination requirements in order to qualify as tax exclusions. In general, statutory fringe benefit plans must be nondiscriminatory with respect to eligibility, contributions and benefits. If a plan is determined to discriminate in favor of officers, shareholders or highly compensated employees, the otherwise applicable income exclusion is denied.

[2] The prescribed percentage is 0.5 for 1983 and 0.75 for 1985, 1986 and 1987.

Sources: Joint Committee on Taxation, "Pamphlet Prepared by Joint Committee on Taxation on Administration Proposal to Tax Employer Provided Medical Insurance and Explanations of Tax Treatment of Benefits" (June 1983), and Peter Henle and Jane G. Growelle, "Employee Stock Ownership Plans: Current Status and Proposed Legislation," Congressional Research Service Multilith No. 75–159E (July 1975).

The second major development was an increase in the list of services that could be provided tax free by employers for their employees. These include prepaid legal services, employer-provided transportation by commuter van between home and work, educational assistance for tuition, books and supplies, and dependent care assistance for children and incapacitated dependent adults. The only requirement is that these benefits be provided on a nondiscriminatory basis that does not favor officers, shareholders, or highly compensated employees.

A third innovation was the encouragement of so-called "cafeteria" plans that allow employees to select from a menu of benefits and salary packages with a variety of health, vacation, insurance, retirement and other benefits. This development became possible with the enactment of Section 125, which removed restrictions established under ERISA for cafeteria plans that offered the option of cash or a taxable benefit. Essentially, ERISA said that the right to elect cash or a taxable benefit constituted "constructive receipt" even if the employee did not actually make such an election. The 1978 legislation provided that the application of tax was to be based on the actual election of taxable benefits, and thereby paved the way for the establishment of cafeteria plans covering a wide range of taxable and nontaxable benefits.

The same legislation also authorized so-called section 401(k) plans that allow employees to reduce their salary by up to 15 percent of compensation and invest the money tax free in a special account. As in the case of pension plans, interest is also allowed to accumulate tax free until the funds are distributed. Legislation passed in 1980 permitted 401(k) plans to be part of a cafeteria plan.

Recent surveys indicate a dramatic expansion of 401(k) plans and substantial interest in cafeteria plans, despite the absence of final IRS regulations on the former and proposed regulations on the latter.[8] Information reported by Hewitt Associates indicates that by the end of 1983, 60 firms had implemented cafeteria plans and 40 more were expected to do so in January 1984. Section 401(k) plans are continuing to expand among large firms and are increasingly being adopted by middle-sized firms. which is surprising since innovations in benefits generally take some time to trickle down from the largest employers. Nevertheless, a recent survey by Meidinger, Inc. indicated that half of the medium-sized firms who responded to the survey (256 firms in 38 states) said they were taking positive action toward adopting 401(k) plans or already had such a plan in place. Clearly, the addition of cafeteria plans and 401(k) plans to the list of statutory benefits is going to contribute to an increasing ratio of benefits to compensation over time.

Nonstatutory benefits

In addition to introducing new statutory employee benefits, Congress has also been deliberating about awarding statutory standing to a list of benefits that have generally been viewed as tax-exempt by the public. Although the 1983 legislation was originally introduced in an attempt to tighten up the rules for the taxation of nonstatutory employee benefits, the bill was amended so heavily in subcommittee that the version reported to the full House essentially codified existing employer practices.[9] Under the proposed legislation, fringe benefits offered by the employer on a nondiscriminatory basis would be excluded from taxable income if they qualified under any one of the following categories: (1) Services provided at no additional cost to the employer, such as airline seats to airline personnel and their families; (2) Qualified employee discounts up to 20 percent for goods sold in the normal course of the employer's business; (3) Benefits used in the employer's work, such as a company car, if at least 85 percent of the benefit would be classified as work related; (4) Other benefits that fall under a de minimis exclusion, such as picnics for company employees, small Christman gifts, and subsidized cafeterias. In addition, special exemptions would be allowed for qualified tuition reductions, employee parking, and athletic facilities so long as these benefits were provided to all employees on a nondiscriminatory basis.

Although no action was taken on employee benefit legislation in 1983, it appears only a matter of time before the list of statutory fringe benefits is expanded, thus encouraging even greater use of noncash compensation by employers.

III. OPTIONS FOR REFORM

Since the social security trustees' projected increase in the ratio of benefits to compensation appears roughly correct, the pertinent question is whether this trend is acceptable or whether some changes should be made in the tax code. Arguing for reform are two factors: First, excluding a major component of compensation from the tax base introduces obvious inequities. Two individuals, who are equally well off in an economic sense, pay different amounts of income and payroll taxes over their lifetimes. The exclusion also has an adverse effect on the distribution of income. Fringe benefits are concentrated among higher paid employees and under the income tax the value of exclusion and deferral increases with a worker's marginal tax rate, yet all taxpayers must pay higher income and payroll taxes to compensate for the favorable tax treatment accorded employee benefits. The second problem is that excluding a major component of compensation greatly reduces the size of the tax base, forcing Congress to increase income and payroll tax rates in order to raise a given amount of revenue.

The pure solution

The theoretically pure solution to the problems associated with the erosion of the tax base and the inequities among individuals would be to establish a comprehensive difinition of compensation for both the income and payroll tax purposes. Under such a definition, the value of the employer's contributions for health and life insurance and the increase in the value of accrued pension benefits would be included in the employee's income. Employer contributions for dependent care, van pooling and educational assistance would also be included in income, and salary reduction schemes, such as 401(k) plans, would be repealed.

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[8] "Firms Taking the Plunge into 401(k), Cafeteria Plans Despite Lack of Rules," BNA Pension Reporter, Vol. II, No. 4 (Jan. 23, 1984), p. 93.

[9] The original legislation, H.R. 3525, "The Permanent Tax Treatment of Fringe Benefits Act of 1983," was introduced on July 12, 1983 by Reps. Fortney H. Stark (D-Calif.) and Barber B. Conable, Jr. (R-N.Y.).

This reform would not be extraordinarily difficult to implement. Premiums for health and life insurance could be easily estimated for individuals and reasonable values for other employer-provided benefits could also be established and included in taxable income. The increase in the value of accrued pension benefits is already calculated annually in the aggregate for individual plans to satisfy the disclosure requirements of the Financial Accounting Standards Board. Since the aggregate figure is derived from individual calculations, it would be relatively easy to provide an estimate for each vested employee of annual accrued benefits.[10]

Partial solutions

Should such a dramatic restructuring of the tax code be politically unacceptable, however, a number of other alternatives could be used to include particular benefits in the tax base.

An option for pensions

An alternative option for eliminating the tax expenditure associated with pensions is to adopt the treatment currently applicable to those plans that fail to meet the IRS nondiscrimination, participation, or vesting requirements. In the case of these "nonqualified" plans, an employer may deduct pension contributions only in the year that they are included in the employee's taxable income. In addition, investment income of nonqualified trusts is not tax exempt. Thus, one approach would be to continue to allow the individual to deter taxation on employer pension contributions until retirement, but prohibit deductions by employers until benefits are taxed to the individual. Pension fund earnings would also have to be included in the employer's taxable income each year. While treating all pensions as nonqualified plans would not eliminate the inequities between those individuals with and without pension coverage, it is a workable approach that would restore foregone revenues.

Administration's health insurance option

Another option is the Reagan administration's proposal, included in its 1984 and 1985 Budgets, to tax a portion of employer-provided health insurance by placing a ceiling on the amount of subsidized premiums that employees could exclude from their taxable income. Specifically, the Administration has proposed that employees be required to pay social security and income taxes on employer-paid health insurance premiums in excess of $175 per month or $2,100 per year for a family plan, and in excess of $70 per month or $840 per year for a single plan. Employer-paid health insurance premiums below these amounts would still be excluded from taxation. The $175 and $70 amounts would be indexed to rise with inflation. Although this proposal has met with strong opposition, it is certainly a step in limiting the erosion of the tax base.

Options for cafeteria plans

Several options are also available for cafeteria plans. The widespread adoption of cafeteria plans that include cash and deferred compensation in the list of benefits will seriously erode the tax base and create equity problems. Without cafeteria plans, practical limits exist on the extent to which employers would provide nontaxable benefits in lieu of wages. For any particular benefit, such as health insurance, some employees, say, those without dependents, would resist a general reduction in wages to provide more extensive family coverage. Once a cash or deferred compensation option is available, however, the employee without dependents will no longer have an incentive to oppose the introduction of more extensive health care benefits, since he can receive an equivalent amount in cash.

Discriminatory use of nontaxable benefits can also result from cafeteria plans with cash options. Even though cafeteria plan benefits are made available on a nondiscriminatory basis, the selection of nontaxable benefits may exhibit a pattern that favors higher income employees.

The options for reform include repealing Section 125 of the I.R.C. to reinstate the principle of constructive receipt, disallowing or severely limiting cash or deferred compensation options in a cafeteria plan, restricting cafeteria plan options to statutory benefits as suggested by the Administration, or even further limiting cafeteria plans by removing those statutory benefits with a potential for abuse, such as dependent care assistance. These restrictions would still allow cafeteria plans to function as a legitimate mechanism for tailoring benefit packages to satisfy the diverse requirements of a heterogeneous workforce and for altering the mix of benefits to meet the changing needs of individuals over their careers. Regardless of the approach taken, reform is crucial, since uncontrolled growth of cafeteria plans will inevitably have a deleterious impact on federal tax revenues.

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[10] Some problems, however, still surround the appropriate treatment of nonvested employees. Including in income the full value of accrued benefits would be unfair to those who never become vested, while delaying all taxation until vesting would produce a significant increase in taxable income in that year. A compromise for nonvested employees might be to include in annual income the increase in the value of accrued benefits multiplied by the probability of reaching the vesting age.

The 401(k) option

The foregoing discussion has proceeded on the assumption that the income and payroll tax bases are identical and that reform must be directed at both taxes simultaneously. This is not the only alternative, however, in the wake of changes made in the tax code as part of the 1983 Social Security Amendments. The codification of the Rowan decision provides that an exclusion of income from income tax withholding shall not affect the treatment of income for payroll tax purposes. The first application of the new provision was the inclusion of employee contributions to 401(k) plans in the payroll tax base even though they are deductible under the income tax. With the framework in place to treat employee benefits differently under the two taxes, one possible approach would be to include all nontaxable benefits in the payroll tax base immediately and to approach the income tax reform benefit by benefit.

An aggregate approach

Two factors, however, argue against reforming the treatment of employee benefits on an item by item basis. First, each fringe benefit has a strong constitutency that resists any change in a particular provision. Second, an attempt to limit one benefit often produces new approaches for accomplishing the same goal. Nowhere is this more evident than in the emerging interest in Voluntary Employee Benefit Associations (VEBAs), in the wake of the limits placed on qualified pension plans under the Tax Equity and Fiscal Responsibility Act of 1982. For these reasons, a preferable approach might be one that treats all employee benefits in the aggregate and establishes a limit on the portion of total compensation that any employer can provide in tax free benefits. Contributions above that amount would be included in the employer's payroll tax base and in the employee's earnings for both income and payroll tax purposes.

The level at which the limit should be set would, of course, be difficult to determine, extremely controversial, and by necessity somewhat arbitrary. While for the economy as a whole in 1983 agreed-upon benefits amounted to 9.8 percent of total compensation, substantial variation existed among industries. Of course, even greater variation exists among individual firms and even among individuals within a given firm. Because health insurance, a major component in the benefit package, does not increase proportionately with income, average workers tend to receive a larger share of their compensation in nonwage benefits than high-paid employees.

The task, then, would be to select a level that will restrain the erosion of the tax base, without subjecting most of the workforce to an immediate increase in their tax liability. The number should certainly be above the 9.8 percent national average in 1983 and probably higher than the 12.5 percent in manufacturing. Perhaps, 15 percent of total compensation might be reasonable if a single figure had to be selected. A preferable approach, however, would be to allow a generous amount of nontaxable benefits as a percentage of compensation at lower income levels and reduce the percentage as income increases. For example, nontaxable benefits could account for 25 percent of the first $40,000 of compensation, 15 percent of the next $40,000 and 5 percent of anything over $80,000.[11]

Although this proposal would have little immediate impact on revenues, the distribution of the tax burden, or the structure of employee benefit plans, it would force employees and employers in the future to compare carefully the advantages of alternatives, such as defined benefit pension plans or 401(k) salary reduction plans, rather than simply piling one benefit on top of another. In the long run, this change would slow the expansion in the noncash component of compensation, cap the growth of the nontaxable employee benefits, and prevent the continued erosion of the payroll and income tax bases.

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[11] A variable limit was suggested by Francis M. Vitagliano of U.S. Pension Trust, Boston, Mass.

IV. CONCLUSION

The major conclusion that emerges from the analysis of the expansion of noncash compensation is that, in the absence of regulatory restrictions to curb the growth, this component will continue to account for an increasing percentage of total compensation. While coverage for the major statutory benefits is unlikely to expand at this point, many avenues still exist by which noncash compensation can grow as a percentage of total compensation, and substantial interest exists in taking advantage of these opportunities.

The 1978 reversal of the ERISA concept of "constructive receipt" in the case of cafeteria plans leaves enormous room for the development of innovative employee benefit plans. Moreover, the employee benefit consulting firms have formed a strong lobbying group to pressure Congress and to promote actively the adoption of flexible benefit programs. These efforts, in conjunction with an expanding list of statutory benefits, will almost certainly result in a continued expansion of employee benefits and a corresponding contraction of the payroll and income tax base.

For those who support the concept of using a comprehensive measure of economic well-being as an index of taxpaying capacity, the treatment of employee benefits under the payroll and income taxes is disconcerting. The three primary statutory employee benefits—pensions, group health and group life insurance—clearly provide the recipient with an increment to his economic wellbeing. By excluding the value of these benefits from the tax base or deferring taxation until the recipient faces lower marginal tax rates, the current tax structure distributes the tax burden inequitably. If these generous provisions are continued for the growing array of employee benefits, both the payroll and the income tax bases will be reduced to the point where they can no longer be considered even approximations of ability to pay.

In addition to undermining the equity inherent in a broad, comprehensive definition of income, the expansion of nontaxable compensation will have serious implications for federal tax receipts. In a year when federal deficits were the primary concern of economic policymakers, the 1983 budget included nearly $64 billion in revenue loss to the net exclusion of employer contributions for group health and life insurance and pension benefits. In addition, payroll tax receipts were an estimated $21 billion lower due to the preferential treatment of agreed-upon employee benefit. Moreover, the revenue losses associated with the major statutory benefits are projected to grow substantially, amounting to $192 billion by fiscal 1988 (see Table 5). No estimates are available for the potential revenue impact from the proliferation of cafeteria plans and 401(k) salary reduction plans.

This type of erosion of the income and payroll tax bases is simply not acceptable. At a minimum, a limit should be established on the aggregate amount that employees can receive tax free.

TABLE 5.—PROJECTED REVENUE EFFECTS UNDER THE INCOME AND PAYROLL TAXES FROM "AGREED-UPON" EMPLOYEE BENEFITS, 1984–88

[In billions of dollars]

Benefit	1984	1985	1986	1987	1988
Group health insurance	−30.9	−35.2	−40.2	−45.8	−52.2
Income tax	−21.3	−24.3	−27.7	−31.6	−36.0
Payroll tax [1]	−9.6	−10.9	−12.5	−14.2	−16.2
Group life insurance	−3.3	−3.6	−4.1	−4.3	−4.7
Income tax	−2.3	−2.5	−2.7	−3.0	−3.3
Payroll tax [1]	−1.0	−1.1	−1.4	−1.3	−1.4
Pensions and profit sharing	−70.1	−82.2	−96.9	−114.4	−134.9
Income tax	−56.6	−66.4	−78.3	−92.4	−109.0
Payroll tax [1]	−13.5	−15.8	−18.6	−22.0	−25.9
Total revenue effect [1]	−104.3	−121.0	−141.2	−164.5	−191.8

[1] Revenue effect under payroll tax calculated by author assuming the ratio of revenue loss under the payroll tax to revenue loss under the income tax remains constant at the 1983 level through 1988.

Source: Congressional Budget Office, "Tax Expenditures: Current Issues and Five-Year Budget Projections for Fiscal Years 1984–88" (CBO, 1983), Table A–1, pp. 55 and 56.

APPENDIX—TAX EXPENDITURE ESTIMATES FOR PENSION PLANS

The U.S. Treasury's estimates for revenue loss or tax expenditures for pension plans have been the focus of considerable controversy. In April 1983, the Employee Benefit Research Institute (EBRI) published a brief article entitled "Retirement Program Tax Expenditures: A Case of Unsubstantiated, Undocumented, Arbitrary Numbers," that initiated the debate over the accuracy of the estimates. A primary concern of EBRI was that the figures published by the Treasury jumped dramatically and apparently without explanation from year to year. For example, for fiscal year 1982 the estimates increased from $16.8 billion in the 1981 Budget to $27.9 billion in the 1982 Budget, and then to $45.3 billion in the 1984 Budget.

The Treasury explains the repeated revisions as attempts to update and improve the estimates. The jump between the 1981 and 1982 budget can be ascribed primarily to revised estimates of the earnings on pension fund reserves and an increase in the marginal income tax rate from 25 to 29 percent. The second jump reflects the inclusion of the federal civil service retirement system and state and local retirement plans and another increase in the marginal tax rate to 30 percent. The question remains, however, whether the figures as they are presently constituted accurately reflect the revenue loss associated with the favorable tax treatment of pensions.

Since the revenue loss figures calculated by the author are very close to the tax expenditure numbers published in the Budget, they can be used as a basis for assessing the reliability of the Treasury estimates. On the one hand, two arguments could be made that the calculated figures in table 1 exaggerate the impact of employer-sponsored pension plans on tax revenues. First, earnings on pension fund reserves may be overstated, since they were calculated by applying the Treasury bill rate to reported data on plan assets. This approach was taken, however, in order to avoid the large fluctuations that would result from calculating year-to-year changes in the value of pension reserves. Second, employer contributions to private plans overstate the cost of current benefits, since the contributions include amounts to amortize accumulated unfunded liabilities as well as to cover benefits earned in a given year. On the other hand, the revenue loss for public plans is almost certainly underestimated, since these plans are not fully funded and hence contributions are less than the cost of accruing benefits. This is particularly evident in the case of the federal civil service retirement plan where contributions reported in the National Income and Product Accounts amount to only 19 percent of payrolls, while the employer's share of "normal cost," that is, the actuarial cost associated with benefits accrued in a given year, is estimated to be 30 percent of payrolls. Moreover, the revenue loss calculations do not include any estimate for the tax expenditure associated with military pensions. In view of the offsetting errors, then, the Treasury's current estimates of the tax expenditure for pension plans probably provide a reasonable approximation of the revenue loss each year associated with the deferred taxation of accrued pension benefits.

The Treasury's tax expenditure estimates are, however, computed on a cash flow basis. Essentially, the calculation is designed to measure how much higher federal revenues would be in a given year if a particular subsidy had not been enacted. this approach is consistent with the expenditure aspect of the federal budget and is meaningful for permanent deductions and exclusions, but it does not properly account for tax concessions in those cases where tax payments are deferred. Its limitations for qualified pension plans are seen clearly by considering a situation in which (1) annual contributions to private plans and pension fund earnings exactly equal benefit payments during the year, and (2) workers face the same marginal tax rate in retirement as they do during their working years. Under these assumptions the revenue loss would equal zero, according to the Treasury calculations of tax expenditures. Yet individuals covered by private plans would continue to enjoy the advantage of deferring taxes on employer contributions and investment income until after retirement. Clearly, such tax deferral is equivalent to an interest-free loan from the Treasury and reduces the present value of taxes to be collected from an individual over his lifetime.

A direct estimate of the annual revenue loss resulting from deferral would be the difference between (1) the present discounted value of the revenue from current taxation of employer contributions and pension fund earnings as they accrue over the employee's working life, and (2) the present discounted value of the taxes collected when the employer's contributions and investment returns are taxable to the employee after retirement. To estimate the annual tax expenditure for employer-sponsored plans in this way requires assumptions about the average age of covered workers, the typical retirement age, life expectancy at retirement, the rate of earnings on pension reserves, the appropriate discount rate, and marginal tax rates for workers and retirees. In the following calculations the typical retirement age is assumed to be 62 and the participants' life expectancy upon retirement is assumed to be 18 years. For consistency with assumptions underlying the treasury estimates, contributions to employer-sponsored pension plans in fiscal 1984 are assumed to be $122.0 billion, the marginal tax rate for workers covered by a pension plan is 30 percent, and the marginal tax rate for pension plan beneficiaries is 18 percent. Because of the sensitivity of the results to the other assumptions, a number of estimates are calculated based on alternative values for the average age of a covered worker and on differences between the rate of return on pension reserves and the discount rate.

This exercise reveals that deferring taxes on 1984 employer contributions and on the earnings on those contributions until retirement, combined with a significantly lower marginal tax rate in retirement will reduce tax revenues between $45.4 billion and $61.5 billion in present value terms (see Appendix Table 1). For instance, if the typical worker covered by a pension plan were 35, and if the earnings on accumulated contributions were 9 percent and the discount rate 7 percent, then the tax expenditure calculated for fiscal 1984 contributions on the present-value basis would be $56.9 billion. This compares to the Treasury tax expenditure estimate calculated on a cash basis of $50.5 billion for fiscal 1984.

It could be argued that the tax benefit for pension plan participants should be limited to the value of deferral, and the rate effect that results from the progressive tax structure ignored. focusing solely on the revenue loss from deferral, the present-value estimate of the tax expenditure becomes $34.5 billion for the 35-year old individual and an assumed interest rate of 9 percent. Thus, the revenue loss associated with the favorable treatment of pension contributions and earnings is substantial regardless of how it is measured.

Although this analysis provides some information with which to compare alternative estimates of tax expenditures associated with employer-sponsored pension plans, it is by no means intended to produce a precise estimate of this expenditure. In fact, the debate over the precise magnitude of the tax expenditures is an unproductive digression that diverts attention from the important topic of tax reform.

APPENDIX TABLE 1.—ALTERNATIVE ESTIMATES OF COST TO TREASURY OF FAVORABLE TAX PROVISIONS FOR EMPLOYER PENSION PLANS,[1] FISCAL YEAR 1984

[In billions of dollars]

Rate of return on plan assets	Average age of covered worker			
	Thirty	Thirty-five	Forty	Forty-five
Estimate A [2]				
8 percent	60.9	56.3	51.1	45.4
9 percent	61.5	56.9	51.7	45.8
Estimate B [3]				
8 percent	45.5	40.0	36.3	31.5
9 percent	36.3	34.5	31.9	28.5

[1] Includes private pension plans, Federal Civilian Retirement System, and State and local retirement systems.
[2] Tax rate is 30 percent in working years and 18 percent during retirement.
[3] Tax rate is 30 percent during working years and retirement.

Mr. **Gibbons**. Thank you, ma'am.

Our next witness is Mr. Halperin.

STATEMENT OF DANIEL HALPERIN, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER, AND FORMER DEPUTY ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Mr. **Halperin**. Thank you, Mr. Chairman.

Mr. **Frenzel**. Mr. Chairman, I am going to have to go over to the floor. There is an extension of the Export Administration Act.

I simply want to thank the panel for their testimony, and particularly welcome back Mr. Halperin, an old friend, who has had particularly good things to say about our procedures. He has been quoted in certain periodicals. I think it has been very helpful to us and I want to thank him particularly for that.

Mr. GIBBONS. We want everybody to know, any time you say something nice about us we read it. So you are encouraged to say something nice. Not only you, Mr. Halperin, but everyone else. [Laughter.]

Go right ahead.

Mr. HALPERIN. Mr. Chairman, I appear today on my own behalf and not on behalf of anybody else.

Before I turn to cafeteria plans, I would like to point to two points that are made in my statement about issues referred to in the Joint Committee pamphlet about which I feel very strongly. One is the issue of the VEBA's, voluntary employee benefit associations. I believe the use of those plans should be substantially curtailed, if not eliminated. They are being used as an end run around the qualified plan rules and they threaten the purpose of those rules, which is to provide protection for rank and file employees.

Second, I also believe quite strongly, as I stated in an article which I have written, that the careful compromise of 1978 which permitted cash or deferred profit sharing plans, 401(k) plans, into the Code, depends upon use of an objective test of nondiscrimination, as the committee report says quite clearly. The Treasury has gone to a facts and circumstances test in the regulations. That rule is subject to significant potential abuse and is also inconsistent with the committee's action in 1981 in denying deductions for so-called mandatory contributions by employees.

Let me turn to cafeteria plans and let me say first, I do not object to their use with respect to employees having a choice between purchasing certain types of insurance for life, health, disability, for putting money in cash and deferred profit sharing plans and taking the rest out on a current taxable basis.

I do object to the use of these plans for cash reimbursements, what have come to be called zero balance or zebra accounts or other variations on those words. I think we have to understand what we are talking about. We are dealing with a situation, for example, where say an employee is earning $1,000 a week and he says to the employer: all I want is $800 this week, I do not want you to pay me the other $200. You can hold that back from my salary. But by the way, I have this dentist bill for $200 and I would like you to pay it for me or reimburse me for what I paid for it.

The same money is paid by the employer in either case. The same is received by the employee in either case. I do not think that is what was intended by the 1978 legislation. In my experience, most people, when you tell them they can do that, they say: You are kidding. Why?

It is generally felt that it is an abusive situation, and I think we ought to trust that reaction. I think we have enough troubles in our tax system without having rules in there where anybody who looks at it feels that there is some kind of a scam or abuse going on.

Now, what I have tried to do in my statement is back up that gut reaction, to give reasons why the gut reaction is correct, and let me try to see if I can summarize that briefly.

What we are doing when we give a tax credit or a tax deduction or a tax exclusion for certain types of benefits is really running a sale. We are saying 20 percent off, 30 percent off, 50 percent off, if you purchase medical insurance and do not spend your money on clothes or furniture or otherwise.

But when we do it through the Internal Revenue Code we run a very peculiar sale. The percentage deduction ordinarily depends upon your tax bracket. The higher your bracket, the bigger the savings. And because of that, we can expect the high paid to respond in greater numbers. They, after all, are saving more.

Viewing it as an incentive, it provides the least incentive for those who need it the most, those least likely to provide for life, health or retirement protection.

Viewed as tax relief, it is skewed heavily toward the higher paid. So in most circumstances, we do not give employees deductions. What we do is require that the program be run by the employer. We expect that the employer choice will mean that there will be a more evenhanded distribution of the benefits, and in recent years we have reinforced that by a relatively stricter nondiscrimination test.

When we go to cafeteria plans, we forgo the employer choice. The employee is making the decision whether to purchase certain benefits. What we are doing when we do that is look directly to nondiscrimination and we are saying, if in fact we get nondiscrimination in actual use the purpose is satisfied, we do not have to decide who made the choice to purchase the benefit.

But it is important to recognize one very key thing: The major difference between cafeteria plans and you and I deciding to go out on our own and spend money in a certain way is the supposed existence of this nondiscrimination test, and we have to be very careful about that and we have to ask two things about it: One, can we enforce it; and two, does it really justify a radical difference in tax treatment? I do not believe either of those tests can be satisfied with respect to cash reimbursement, no matter how structured.

Let me focus briefly on dependent care, because I recognize that that is a difficult political issue. There certainly are arguments for recognizing child care expenses as a cost of doing business which should be deducted like other business expenses. Many people believe that that should be done. But clearly, we have not done that directly. Congress has been unwilling to do that directly, and we should not do it by the back door of cafeteria plans.

The present credit for child care has a very different purpose. It is a 30-percent credit for up to $4,800 in expenditures, a maximum saving of $1,440. And in fact it is the reverse of the kind of sale I described before. It is 30 percent off for low-income people, but only 20 percent off for high-income people, and the administration in its budget wants to focus that even more directly. They want to increase the child care credit for the lower paid and they want to eliminate it entirely for people who earn over $60,000 a year.

Now, looked at that way, the child care credit is not an attempt to recognize child care as a cost of doing business, but it is intended to reduce the burden of those expenses for those least able to afford it, not for the high income but for the low income.

When you go to the cash reimbursement for child care, you have a very, very different focus. You have a 50-percent reduction for the high paid people and you have very, very large amounts, not limited to $4,800 a year. That includes the full cost of kindergarten and preschool at expensive private schools, which can be $5,000 and $6,000 a year by itself.

According to one case, it includes summer camp for children. It can include the cost of cooks, the cost of cleaning help around the house. We are talking about lots of money and vast differences in tax liability. If we do not give people that kind of deduction on their own, why do we give it to them when they go through the cafeteria plan program?

Clearly, the fact that somebody else in the company participates in the program cannot be enough to make a difference. Any nondiscrimination would be an accident and not a result of an employer education or the employer facilitating the availability of a benefit.

Second, for reasons I set forth in my statement I do not believe a nondiscrimination test can be reasonably applied, and in my experience many people are not taking it seriously at all. So I think what it comes down to with cash reimbursements we are talking about a lot of paper shuffling, but little difference in substance from an individual purchase.

We should not build a tax system on that facade. If we want to give greater relief for child care expenses or medical expenses, we should do it directly and we should not require the charade of cafeteria plans. We ought to limit those to insurance benefits, which I think was quite clearly the original intention.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF DANIEL HALPERIN, PROFESSOR OF LAW, GEORGETOWN LAW SCHOOL, WASHINGTON, D.C.

Mr. Chairman and Members of the Committee: My name is Daniel Halperin. I am a Professor of Law at Georgetown University Law Center and I have previously served as Deputy Assistant Secretary of the Treasury for Tax Policy. I appear today on my own and not on behalf of any client or organization.

I am generally supportive of the Administration's proposals, but I wish to concentrate in my statement on the issues relating to employee benefits as raised by the Administration, in the Committee Print prepared by the Joint Committee for this Hearing and by the Internal Revenue Service's February 10 News Release relating to "flexible benefit" plans. I hope to show why corrective legislation is essential.

The impact of the existing complex tax treatment of employee benefits can be briefly summarized as follows:

(1) If wages are directed to certain preferred items, for example, life, medical or disability insurance or dependant care, then under certain circumstances such wages are not subject to tax.

(2) If wages are set aside for future use during retirement or for certain types of so-called "welfare" benefits then again under certain circumstances the earnings on the amounts set aside are not subject to tax. A tax-free buildup of funds is permitted. (As described later, deferral of tax is also an advantage under certain conditions.)

"Flexible benefit" ("cafeteria") plans and voluntary employee benefit associations (VEBAs) are being used in ways that are inconsistent with the intent of existing law. A tax-free buildup for compensation that will be deferred for any significant period should permitted only under the rules established for so-called "qualified" plans. The use of VEBAs or non-qualified arrangements to produce similar results should be precluded.

Cafeteria plans are on their face inconsistent with the general approach of the Code to reserve the most favorable tax result for employer provided benefits, while denying a deduction for individual spending on similar items. Therefore, they must be approached with caution. I believe their role should be limited by specific legislation to flexible benefit plans which provide a choice between the purchase of tax-favored insurance protection (life, health, disability, legal services), contributions to cash or deferred (Section 401(k)) profit-sharing plans and taxable cash distributions during the year (or if absolutely essential within a very short time after the end thereof). Insurance would include any arrangement under which the employee shifts the risk of future expenditures to an employer or third party including HMOs or self-insurance. The use of Cafeteria plans to provide tax-free reimbursement for current expenditures for medical or dependent care is inappropriate.[1]

Characterizing the type of permitted benefits by legislation is a more promising and consistent avenue than the approach of IR 84-22 which is dependent upon the timing of the election and to a greater extent of the purported risk borne by employer or employee. The Treasury position is ambiguous and while I believe it is reflective of sound policy, it unquestionably will be challenged by taxpayers. Legislation would also permit settlement of the very difficult question of effective dates.

I recognize that what I am proposing is inconsistent with both the provisions of Title V of HR 4170 and the Administration's Budget (I also recognize that this is an election year) but if there is widespread legitimate concern with the abusive use of flexible benefit programs, which I believe there is, I think reflection will convince us that focusing on allowable benefits is the most sensible way to deal with such concerns.

CAFETERIA PLANS

In general

The tax exemption for wages directed to certain purposes must be intended to increase spending for the favored commodities beyond what would occur if individual choice were not deflected by potential tax savings. Obviously, the incentive is misdirected if we believe (as many appear to with respect to medical care) that we are spending too much for the preferred item.

Concern that the incentive is ineffective (when the revenue loss is compared to the increased use of the favored item) or, worse, undesirable is tempered somewhat if utilization is so widespread and even-handed that the exemption can be viewed as roughly comparable to an across-the-board tax reduction on wage income accomplished by excluding a certain portion of wages from tax (some may view this as not inappropriate in light of the multiplicity of special tax benefits for investment income).

The simplest way to encourage spending for the favored commodities would be to grant employees tax deductions for wages so spent as we do, for example, for charitable contributions or mortgage interest. But this route would neither provide a sensible incentive nor can it be regarded as providing a fair or even-handed tax cut. Why is this so?

Tax-exemption amounts to a price reduction equal to the taxes saved by accepting wages in the tax-favored form. When a department store runs a sale the savings are the same for all who fight the crowds. The Internal Revenue Service, on the other hand, runs a peculiar "sale". The higher your marginal tax rate, the larger the price cut. It is obvious that those in the higher brackets are much more likely to respond.

The incentive for those who, if left to their own devices, are least likely to provide insurance protection or save for their retirement, is the weakest. Moreover, viewed as an alternative to a rate-cut, a tax deduction for individual spending will tilt the tax relief very heavily toward the upper end.

Thus, we are not allowed to deduct the cost of individual life or disability insurance and can deduct medical insurance premiums only in the limited circumstances that all medical expenses exceed 5% of gross income. However, if the employer provides wages in this form and never lets us get our hands on the cash, wages are exempt.

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[1] It is generally agreed that non-statutory fringe benefits should be excluded from cafeteria plans. If the value of such benefits to the employee is known and the employee in fact bears the burden of the expense, the purported arguments for exclusion are dissipated. As under present law, education benefits should also be excluded for the reasons discussed below applicable to medical and dependent care. Moreover, I believe the only valid justification, if any, for § 127 must be the purported difficulty of distinguishing between deductible and non-deductible education expenses which argues for using employer willingness to bear the burden as a proxy for establishing the business connection. With a cafeteria plan, the burden is not on the employer.

This seeming inconsistency is only explainable by the belief that if the choice is left to the employer, particularly if there is a non-discrimination requirement and a limitation on the proportion accruing to the highly paid, as there increasingly is, the benefits will be provided more evenly. How then do cafeteria plans fit in? The very essence of flexible benefits is employee choice which is abhorrent to the goal of even-handed usage.

Nevertheless, there are a number of reasons why cafeteria plans seemed desirable. Giving the choice to the employer is wasteful if the employee would make a different selection. While in some cases the very purpose is to provide an employee with a benefit he would not choose ("big brotherism"), in other cases it would be recognized that the provided protection (e.g. life insurance for someone without dependents) is undesirable.

Further, and perhaps more important, enormous pressure is placed on being able to determine who initiated the purchase, if the tax treatment depends on who made the decision rather than on how the money is spent. It is best to avoid this pressure if we can. Certainly, when the compensation package is shaped in private negotiations, it will be difficult to tell whether the employee exercised a choice.

Therefore, the 1978 legislation, which for the first time specifically sanctioned cafeteria plans and cash or deferred profit-sharing plans was probably appropriate. But it is essential to keep in mind what distinguishes cafeteria plans from individual purchases. It is quite simply non-discrimination in actual utilization of the favored benefit. Under cafeteria plans, rather than relying on employer choice as a proxy to insure even-handed usage, we look to the actual pattern of use. If this is non-discriminatory, at least within the particular group, then individual choice can be tolerated. It is particularly rational to do so if widespread usage is a result of the educational and promotional efforts of the employer developed in response to the non-discrimination requirement.

Again it must be emphasized that actual non-discriminatory use is essential. It cannot be mere *opportunity to choose.* If this were all that were required, it would be much simpler to provide individual deductions and not involve the employer. Further, with employer choice eliminated as a factor, the difference in tax result is riding solely on the non-discrimination requirement. If it cannot be sensibly applied, the favored treatment rests on a facade. Purported tax-free cash reimbursements under flexible benefit plans are objectionable for a number of reasons but one surely is that a non-discrimination test is nearly impossible to apply if not virtually meaningless.

Cash reimbursements for medical and dependent care

Individual expenditures for dependent or medical care are today aided by tax benefits in limited amounts or in narrowly confined circumstances. Conceivably, arguments could be made for more open-ended and generous relief. But in the absence of such change it is clear to me that the possible application of a non-discrimination test under flexible benefit plans is insufficient to justify a radically different policy for expenditures under such plans as compared to private expenditures generally. This is particularly true in the case of dependent care where the amounts can be quite large raising serious questions of horizontal and vertical equity.

Even if one disagrees, there are strongly collateral reasons for distinguishing between the purchase of insurance (as defined above) under cafeteria plans which seems acceptable, and cash reimbursements which do not. These include the ability to ascertain whether the claimed expenditures are actually made, the feasibility of a non-discrimination test and the public reaction concerning whether the program seems equitable or looks like a scam. Each of these points will be discussed after the development of the basic policy question.

Policy concerns

The Internal Revenue Code permits medical expenses to be deducted if they exceed 5% of adjusted gross income. This reflects more a recognition of the impact of unusual expenditures on ability to pay rather than a means of encouraging or facilitating expenditures for medical costs.

Dependent care expenditures up to $4,800 per year ($2,400 of these is only one qualified dependent) may entitle a taxpayer to a credit against tax for up to $1,440 per year, for those with adjusted gross income of $10,000 or less, reduced to a maximum of $960 for higher income individuals. The Administration has proposed further concentration of the credit on low income individuals, increasing the amount for such persons (to a maximum of $1,920 at $10,000 and $1,600 at $20,000) and phasing out the credit so as to make it unavailable to higher earners with adjusted gross income in excess of $60,000. While many believe that child care costs should be recognized, like a business expense, as a cost of going to work, the present credit has a very different origin, namely, to reduce the cost of child care significantly, not for all, but principally for those least able to bear the burden. (The tax deduction for second earners is more directed to the additional costs when there are two in the family working outside the home.)

Tax-free reimbursements under cafeteria plans would radically change the benefits for expenditures for both medical and dependent care even though the choice of the amount to spend remains with the employee. The exclusion focuses the benefit on higher income persons and is available for limited amounts for dependent care far in excess of $4,800 per year. It may include the cost of household help, for example, for cooking or cleaning which is not directly related to dependent care, as well as kindergarten and pre-kindergarten programs at expensive private schools (Treas. Reg. § 1.44A-1(c)(3)) or even summer camps (Edith W. Zoltan, 79 T.C. 490 (1982)).

Can this be justified merely because of the possible application of a non-discrimination test. I think not. It may be possible to believe that the non-discrimination requirement causes the employer to develop programs which encourages employees to provide protection against death or illness or for retirement needs but it seems much less likely that similar efforts will have an important effect on the choice of dependent care or medical services. If a non-discriminatioin test is satisfied, it would seem more likely to be the result of accident or perhaps self-selection of job applicants if the existence of the program is known.

It also seems that the cost from individual to individual can vary much more than the usual difference in insurance costs raising substantial equity concerns. Depending on the circumstances, flexible benefits can lead to greater or lesser use of tax-free benefits. To the extent an option to take cash will cause some employees to forego the tax advantage of pre-existing programs, the tax base will increase. On the other hand, employers will no longer be constrained to limit benefits to the kind and quantity desired by the vast bulk of employees. Since this will allow those who desire more expensive or less common benefits to increase the portion of their compensation in tax-free form, it is of significant concern. First, there is a danger of substantial narrowing of the tax base. Further, unless the non-discrimination test can be implemented, there will be serious problems of vertical equity. Even if discrimination can be prevented, horizontal equity may suffer as there can be large differences in the tax liability of those with equal income. In these circumstances, it seems essential to be certain that the tax incentive is consistent with public policy—either it modifies behavior in accordance with the concerns of public policy and to a sufficient extent so as to justify the cost and the disparity in tax burden or its produces differences in tax liability which are acceptable on other grounds such as ability to pay. These questions require more open discussion and debate. Decisions should not be implemented through the back door of flexible benefit programs.

Collateral impacts

Wide spread cheating can be expected if cash reimbursements are excluded from tax. Under so-called zero balance plans or ZEBRAs the employer's costs are unaffected by employee claims for reimbursement for medical or dependent care. Since the employer's total payments are the same in either case, the employer has little reason to police or question the employee's claim. (The employer does have to have a reasonable basis to justify any reduction in the amount of tax withheld.) While the same is true in the case of the choice of insurance protection, in that case the employer forwards the premium and can be sure that the amounts are spent on the tax-favored benefits. The employer does not deal with the babysitter or the dentist.

The requirement that actual use be non-discriminatory cannot be sensibly applied to cash reimbursements. It is certainly clear that the standard to be utilized has not been developed. Since neither dependent or medical care involve income replacement, the strongest test would be to insist upon relatively equal dollar amounts for the average employee at each income level. This test can be applied but it ignores the usual approach that suggests we compare employees who are similarly situated.

If the purpose is to reduce the price of medical care so that employees would be more likely to seek attention, then similarly situated would seem to be two employees who have a toothache of equal intensity. Obviously there is no way to know. If we look only to amounts spent, not only is the test automatically satisfied nullifying it completely but also it overlooks the fact that lower income people who have more needs and less potential tax saving may have ignored the pain and resigned themselves to rotting teeth.

In the case of dependent care it seems almost as difficult to sensibly determine who is similarly situated. Perhaps, we should look only to the age of children (but is the availability of older siblings or other relatives in the home relevant). If we consider whether there is a spouse at home, we may have compromised the potential purpose of the exclusion to encourage more women to enter the paid work force. In any event, do we really want the employer to pry into family relationships to this extent?

It is particularly not worthwhile to do so if it would normally appear unlikely that nondiscrimination can be established if the test is equal dollar expenditures. High income employees may use more child care more often; they definitely incur greater expense per capita. Moreover, lower income people would frequently forego the exclusion in order to obtain the child care credit.

Finally, and perhaps more important, it is my understanding that employers and employees alike find it difficult to believe that so-called ZEBRAS can result in tax-saving. From the employee's vantage point he will receive the same amount of cash either way, why should taxes go down merely because he can produce a bill from the dentist or babysitter. One should trust this reaction. The odor casts doubt on the fairness of the entire tax system.

If we determine to allow a tax deduction for the cost of dependent care we should do so directly and not by a transparent scam.

Afterword on medical reimbursement

I understand it is argued that cafeteria plans can reduce expenditures on medical care if employees are offered (or required to take) less expensive medical insurance, perhaps with a deductible, and a cash fund (perhaps equal to the deductible). It is claimed that if the employee can obtain cash if he does not spend the fund for medical care, he is less likely to go to the doctor.

If potential tax-free amounts are limited and reflect no more than the difference in cost between a format expensive first dollar insurance policy and a cheaper policy with a co-insurance feature, cash reimbursement is less objectionable. I note, however, the potential difficulty of determining if the more costly policy is really a viable option. Moreover, this argument turns the whole tax incentive idea on its ear. If we really do not favor first dollar coverage, we should not permit a tax exclusion for its cost. Finally, if we would rather the employee did not use the cash fund for medical costs, then we should not give him a tax benefit conditional on doing so. The employer can still offer cash to employees who choose or are required to take the cheaper policy. Nevertheless, logic aside, I do recognize that the ability to exclude amounts actually spent on medical care may facilitate a desirable change in coverage and that the Administration's proposals to reduce the tax benefits for medical insurance coverage has a doubtful future.

LIMITATIONS ON USE OF VEBA'S

The rules applicable to Voluntary Employee Benefit Associations (VEBAs) should be tightened to preclude their use as an end-run around the restrictions on qualified plans. The purpose for which compensation is used does not affect the fact that it is deferred compensation. There is no reason to distinguish between amounts used for groceries and amounts, which, it is claimed, will be used for life insurance. Both should be subject to the same conditions. A tax-free buildup should be permitted only under the rules applicable to qualified plans. In any event, certainly, the same non-discrimination test should apply. Otherwise, it is too easy to game the system. For example, there is little difference between deferred compensation and the enormous buildup of funds to provide post-retirement life insurance for the owners of the business. This is particularly so if the life insurance is never purchased.

Qualified plans

For more than 40 years and accelerating with the adoption of ERISA in 1974, enormous effort has been expended in trying to perfect the use of tax-qualified pension and profit sharing plans to insure greater retirement security for employees in general and not just the highly paid few.

Obviously, employers do not choose qualified plans for their flexibility. There is a complex set of rules designed to require coverage of the rank and file, to place limits on the amount that can be provided for the highly paid and to insure by way of such means as vesting requirements and employer liability that promised benefits are actually delivered. While we have not achieved perfection (the vesting rules and the ability to integrate with Social Security are prime candidates for further examination), much has been accomplished in retirement protection and in improving the equity in the utilization of tax benefits. These accomplishments should not be compromised by the use of VEBAs or non-qualified deferred compensation, however effect. If high income individuals can obtain the benefits of qualified plans without the loss of flexibility, then the use of such plans will be reduced compromising the retirement security for the rank and file.

Alternative rules

It is easier to say this than it is to design a system to deal with the large variety of arrangements that can be adopted. The search is facilitated, however, if it is recognized that the primary advantage of qualified plans is the tax-free buildup of funds. Immediate deduction for the employer accompanied by deferral for employees is important but less significant.

As discussed by the Administration in its proposals relating to premature accruals, the value of a deduction is not necessarily reduced by a delay in being able to claim it, if the amount is increased to reflect the delay or, conversely, would be decreased if allowed earlier. Thus, measurement problems (and any possible concern with allowing the employer to choose the year to deduct) can be minimized, without harm to the employer, by deferring deductions until amounts are includible in the income of employees (or would be so includible in the absence of a statutory exclusion). Alternatively, if dedfuctions are to be permitted upon accrual or contributions to a fund, it is essential to limit the amount to present value although this is perhaps practically impossible to accomplish when there is one-year acceleration.

For similar reasons, the employee is not necessarily benefitted by a delya in inclusion in income if the amount of income is increased to affect the time value of money. Although the employee is able to achieve the benefit of lifetime averaging of rates, this may not be a significant concern depending upon one's point of view. I note, however, that there are current suggestions for reducing averaging opportunities.

Nevertheless, even if marginal rates remain unchanged and the amount of deduction or income is adjusted to reflect the timing, an advantage remains if assets can be accumulated in a tax-free trust as opposed to being subject to tax in the hands of the employer, employee or outside insurer. Deferring the employer deduction until funds are distributed to or used for the benefit of employees, as is now the rule under section 404, is an indirect means of taxing investment income. (If the employer contributed $1,000 and the employee received $1,500, a deduction of $1,000 can be viewed as the net effect of including $500 in income and allowing a $1,500 deduction). But there are at least two difficulties with this approach. There can be significant tracing problems and taxation of income can be deferred for many years until funds are used. Even if the trust were taxable it may have a lower marginal rate than the employer. It seems better to currently attribute income to the employer, as under a grantor trust, and allow a deduction for the full amount distributed.

I tend to believe that the tax exemption under Section 501(c)(9) or (17) may be totally unjustified, at least where collective bargaining is not involved. If exemption must be retained it should be limited to plans which meet non-discrimination requirements, at the very least those applicable to the underlying benfits, and to income on an accumulation which will be used to provide benefits for employees within the next taxable year. Otherwise, qualified plan restrictions should apply.

This anlaysis should demonstrate a possible means of dealing with the unfinished problem of non-qualified deferred compensation arrangements established by tax-exempt employers or nominally taxable corporations with net operating losses (or which utilize the dividend received deduction). Deferral for employees can be permitted under such arrangements as long as the investment income is subject to tax at rates appropriate for the employee.

This approach could be made part of this Committee's consideration of the time value of money proposals or even its analysis of abuses of § 243.

SECTION 401(k) PLANS

I wish to strongly emphasize my agreement with the suggestion in the Joint Committee Print at page 107 that the statutory objective rules be the sole test of nondiscrimination under section 401(k). The reasons for this conclusion are set forth in my article "Cash or Deferred Profit-Sharing Plans and Cafeteria Plans," 41 NYU Institute on Federal Taxation at 39-18 to 22. Applying a facts and circumstances test as the Treasury does in the proposed regulations fails to follow the 1978 Committee report and is inconsistent with the ERTA rule denying a deduction for mandatory employee contributions. It would also be reasonable as the Print suggests to exclude certain highly paid employees from the lower paid group of employees even if they are within the bottom two-thirds of eligible employees.

I appreciate the opportunity to present this testimony.

Mr. GIBBONS. Thank you.

I would say, Mr. Rogers, before you start, one of your employees, Mr. Friedersdorf, has written me a nice letter and explained to me what you did in PepsiCo, and it is quite interesting.

STATEMENT OF CHARLES W. ROGERS, CHAIRMAN OF THE BOARD, EMPLOYERS COUNCIL ON FLEXIBLE COMPENSATION, AND DIRECTOR OF COMPENSATION AND BENEFITS, PEPSICO, INC., ACCOMPANIED BY WILLIAM W. CHIP

Mr. ROGERS. Mr. Chairman, I am the director of benefits at PepsiCo, but I am speaking to you on behalf of the Employers Council on Flexible Compensation. That organization has nearly 100 major employers as its members, and we also have——

Mr. GIBBONS. Could you get a little closer to the microphone?

Mr. ROGERS. We also have 40 leading benefit plan administrators and insurance companies as members in our organization.

I wanted to speak with you today about the impact of IR 84-22 on private employers in this country. In 1978, this Congress passed section 125, and during that time I have been working inside of a corporation trying to develop benefit programs that were consistent with that legislation, and I can tell you that the other member companies of the ECFC have been making those same efforts.

We have continually come to the IRS and the Treasury for direction and guidance with respect to how we could develop those programs so that they were consistent with the legislative intent of section 125. We have continually had our questions unanswered.

We have also made numerous efforts to work with the Treasury Department and the IRS to develop proposals and regulations which we felt were consistent with the legislative intent and, while we have had a number of conversations with them, all of this has come to naught. So I think it is patently unfair for the IRS to issue 84-22 and apply penalties retroactively to employers who have acted in good faith in developing and designing the benefit programs that they have for their employees.

And I would ask this committee to consider waiving the retroactivity provisions of IR 84-22 and also consider providing employers with a reasonable period of time to adjust their plans to conform to any regulations which may be published subsequent to that announcement.

Another concern that I have—and I may relate it back somewhat to what Mr. Halperin and what Ms. Munnell have said about health care cost containment and about the tax impact of reimbursement accounts. PepsiCo started in mid-1980 to try to take control over the escalating costs of our indirect compensation programs.

What we found was that our medical costs were increasing at close to 18 percent a year, and this compared to wage increases of 8 percent. And we have always felt that direct pay, cash compensation for employees, was the most effective way to pay people.

As part of our strategy, we decided we wanted to try to bend the curve on health care cost inflation and we went in and did a lot of research into that industry to find out the most effective ways to have an impact on health care cost containment. We became convinced that it was only by getting our employees involved in the cost of their health care programs that we could have an impact in this area. As a result, we introduced the section 125 plan in mid-1980 and increased substantially the cost sharing that our employees have in the premiums that they pay for the medical insurance programs that we offer.

It was in 1984 that we added to that program our reimbursement account. We added the reimbursement account so that we could ask our employees to take on a greater share of the overall cost of their medical care and take a greater interest in how they consume health care.

What we found, for example, is that this year over 50 percent of our employees voluntarily selected a medical plan that has $300 individual employee and $600 family deductible and 80 percent coinsurance. This contrasts with last year, when much greater than half of our employees were in a plan that had a $100/$200 deductible and essentially 100 percent copayments.

Employees have voluntarily elected to take on more risk and more responsibility for their individual health care, and through this program they receive a reward for being effective consumers of health care. To remove the opportunity for private employers to use reimbursement accounts to control health care costs, to get employees more involved in the consumption of their health care, and to make certain that they are responsible consumers of that health care, I think is very concerning and it will turn around what has been a very successful program at PepsiCo and one that we can demonstrate.

We have, for example, a very unique situation. There was a 2-year period of time when PepsiCo had about half of our divisions in flexible benefit programs and the other half of our divisions were in conventional benefit programs. There are about 25,000 employees covered all told between those programs and it was about evenly split.

What we found was our year-to-year cost increases in the flexible benefit program were slightly less than 10 percent, and in our conventional benefit programs they were close to 18 percent. We could clearly see that cost sharing was having an impact on consumption, and I think this is an opportunity that American industry can ill afford to pass by at this point.

So the second piece of our 84-22 that concerns me is the forfeiture provision. It is difficult for me as an employer to imagine how I can sell to my employees higher levels of self-insurance and risk and more participation in health care costs if I tell them that the moneys that they deposit into a reimbursement account will be forfeited at the end of the year. I do not believe that we can sell that to our employees and I think it will take the wind out of the sails of what has become a very successful and innovative approach to controlling costs over time.

Thank you.

[The prepared statement follows:]

STATEMENT OF CHARLES W. ROGERS, DIRECTOR OF COMPENSATION AND BENEFITS, PEPSICO, INC., CHAIRMAN OF THE BOARD OF DIRECTORS, EMPLOYERS COUNCIL ON FLEXIBLE COMPENSATION

Mr. Chairman, thank you for the opportunity to testify before this Committee on a matter of critical interest to the members of the Employers Council on Flexible Compensation. The Council is an association of nearly 100 major employers from all regions of the country that are interested in programs of flexible compensation for their employees. Forty of the country's leading group insurance providers and benefit plan administrators are Associate Members of the Council. The Council's membership list is attached to our written testimony.

Flexible compensation simply means that employees are allowed to participate in the design of their own benefit plans. Not very long ago, most employers provided each employee with essentially the same package of benefits. The typical American worker was perceived to be a male between the age of 25 and 55 with a dependent spouse and two children at home. How the employee's total compensation was divided between cash wages and welfare benefits, and how the welfare benefit dollars were divided between medical insurance, life insurance, and other benefits, was decided by the employer, or by the employer and the employee's union, but hardly ever by the employee himself.

This rigid pattern of compensation is no longer suitable for an increasingly diverse workforce. Many employees, particularly those who are older or who have several children, prefer higher degrees of medical, disability, and life insurance coverage than the standard benefit package provides. Younger employees without dependents usually prefer more cash compensation and fewer benefits. Working wives may already be receiving adequate medical coverage from their husband's employers and might prefer dependent care assistance to other benefits.

Since at least 1970, an increasing number of employers have attempted to accommodate the increasingly diverse American workforce by allowing individual employees a greater say in how they will receive their compensation. Originally, so-called "cafeteria plans" allowed employees a choice between two or three levels of group term life insurance, two or three levels of disability insurance, and two or three levels of medical insurance coverage. The employer would commit a certain amount of funds to the cafeteria plan, usually equal to what it had been paying in the past. If the employee selected a package of benefits costing more than the employer's initial contribution, he would have to accept less cash compensation than he would otherwise have received. If the employee selected benefits costing less than the employer's initial contribution, the employee would receive the difference as an increase in his taxable cash compensation.

Although the IRS originally viewed cafeteria plans favorably, it eventually issued regulations suggesting that any employee who could select between taxable cash and nontaxable benefits would be taxed as if he had selected all cash and no benefits, regardless of what he actually selected. Congress intervened in 1978 and added section 125 to the Internal Revenue Code, providing that employees would be taxed on the basis of the benefits they actually selected and not on the basis of what they might have selected instead. There was some concern at the time that rank and file employees might be more inclined than highly paid employees to take most of their compensation in cash, with the result that highly paid employees would utilize nontaxable benefits to a far greater degree than would the rank and file. To avoid this, section 125 contains several rules against discrimination in the availability and utilization of nontaxable benefits.

The experience of employers like PepsiCo that have operated cafeteria plans for a number of years has been encouraging to us and should be encouraging to your Committee. We have found that employees are quite rationale and judicious in allocating their compensation between the various taxable and nontaxable benefits employers can make available. Indeed, we find in many cases that the average union employee would prefer fewer benefits and more cash compensation than their unions have negotiated. In patricular, many employees are willing to accept somewhat less comprehensive medical coverage than is customary if they are entitled to receive additional cash compensation or additional benefits in exchange.

After PepsiCo first introduced flexible benefits, we found that our total expenditures for tax-free medical care under our cafeteria plan rose by only 9% per year, compared to a 17% annual rise in tax-free medical expenditures for employees not covered by the cafeteria plan. This phenomena was not unique to our company. One of the oldest flexible benefit plans in the country, the American Can Company's plan, had almost exactly the same result of cutting the rate of increase in medical expenditures by one half. Although we are quite pleased with substantially cutting the rate of medical cost increase, even under our cafeteria plan medical expenditures continued to rise.

One reason, perhaps the principal reason, why health services are over-utilized in this country is that an employee with traditional insurance protection has no financial incentive to limit his use of such services. All health care experts agree that, without some sort of reward for those who are prudent users of health services, and some form of penalty for those who are not prudent, we will never be able to do more than moderate the rising cost of health care. In order to create a powerful incentive for prudent use of health services, PepsiCo and a large number of other companies have broken from traditional patterns of providing medical protection. Specifically, we have offered our employees, on a voluntary basis, insurance-type protection with some of the highest deductibles and co-payments in the country. For those employees who are willing to accept these high deductibles and co-payments, we have set aside the money saved by the company on insurance premiums in an account for each participating employee. If an employee becomes sick or injured and is forced to incur substantial medical expenses, he can draw on the funds in this account to pay his medical bills. Any amounts that are not spent on medical care during the year are paid to the employee at the end of the year as a taxable cash payment. We are required to distribute these amounts at the end of the year because section 125 of the Code prohibits using cafeteria plans to defer compensation from one year to the next.

The results of offering our employees this financial incentive have been extraordinary. The percentage of employees that elected our most expensive insurance plan fell from 68% to 22%. The percentage electing our least expensive plan rose from 11% to 50%. Our actuaries calculate that our total expenditures for medical insurance premiums will decline by 23% as a result. When the money set aside in the medical reimbursement accounts is taken into account, there still remains a 6% decrease in the total amount of money spent on tax-free medical care by our company for its employees, for savings of $5,000,000. For those familiar with employee health plans, this is an astonishing achievement in controlling health care costs. It is also an encouraging note for those of us concerned about the federal budget deficit since most of that 6% savings in tax-free medical care will be distributed to employees as taxable compensation at the end of the year.

Once again, the PepsiCo experience is not unique. Quaker Oats, one of the first large companies to establish a medical reimbursement account, estimates that its expenditures for tax-free medical care are today 23% less than if they had continued with their traditional medical program. In a number of companies in financially troubled industries, the creation of a medical reimbursement account was an absolutely essential element in obtaining agreement from their unionized employees to lower the total amount of company health care expenditures.

Several weeks ago, the Internal Revenue Service issued a News Release in which it announced that certain types of medical reimbursement accounts were not valid and that employees who had been reimbursed for medical expenses pursuant to such arrangements would have to file amended tax returns and would be subject to interest and penalties on any underpayment of taxes. The principal target of the News Release seemed to be so-called zero balance plans in which no money is actually set aside for the employee until after he has actually incurred medical expenses. Last week, Assistant Secretary of the Treasury Chapoton gave an example of a plan in which money was never set aside for employee medical reimbursement and the employer did nothing more than adjust the employee's W-2 at the end of the year.

The plan described by Mr. Chapoton is not one I had ever heard of before last week, and it is not what I want to talk about today. What concerns my company and other members of the Employers Council is that the News Release strongly implies that my company's plan and nearly every other medical reimbursement plan in existence today is invalid. The principal objection of the IRS to the so-called zero balance plans is that employees do not elect to have any money set aside for medical care reimbursement until after they have already spent the money. It is my experience that most employers either already require that elections be made before the plan year begins or would be willing to do so. Indeed, the News Release implies a number of different requirements that the IRS intends to impose on medical reimbursement accounts. Although we are not convinced that all of these requirements are needed to prevent tax abuse, we and other members of the Council are prepared to accept and comply with most of them, with an important exception. The News Release stated that, while an employee may lawfully elect at the beginning of the year to have a certain amount set aside for medical care, it is not lawful for any of these amounts to be distributed to the employee as taxable cash at the end of the year. Instead, any unused amounts must be forfeited.

There are very few, if any, medical reimbursement plans existing in the country today that require forfeitures. We cannot perceive any requirement of the Internal Revenue Code or any requirement of public policy that should make it necessary that the employer rather than the employee retain these unused funds. On the contrary, requiring forfeitures of unused funds will destroy the very purpose for which we instituted these plans in the first place. If the employee knows that none of the unused funds will be distributed to him at the end of the year, even if he is willing to pay tax on them, he has every incentive to utilize these funds for health services to the maximum extent possible. We believe it is not in the interest of health care cost containment to enforce a forfeiture requirement of the type implied by the IRS News Release.

If the forfeiture principle that was enunciated in the News Release is implemented by the Internal Revenue Service in regulations, then nearly every medical reimbursement account in the country, whether abusive or not, will be eliminated. Many of our member companies have been informed by their attorneys that, in their opinion, this forfeiture requirement is without any foundation in the law. Any attempt to enforce such a requirement will be strenuously resisted by many employers, resulting in many years of litigation until the issue is definitively resolved by the courts. In the meantime, the goal of health care cost containment in this country will take a dramatic leap backwards, since most employers will not be willing to expose their employees to the hazards of litigation during a period of uncertainty.

As early as 1982, one of our member companies, Honeywell, Inc., requested a ruling from the Internal Revenue Service specifically asking whether a medical reimbursement account of the type most companies have implemented was a valid plan under section 125 of the Code. On June 30, 1982, the Internal Revenue Service returned the ruling request stating that the legal issues raised in the request could not be resolved one way or the other prior to the issuance of regulations. As your Committee knows, we are now in 1984 and there are still no regulations. Our company and hundreds of other companies in the country have spent large sums of money designing these plans, educating our employees about how to use them, and setting up the computer banks and other mechanisms for administering them. After six years of refusing to speak a word about cafeteria plans, it is grossly unfair for the IRS to announce and attempt to enforce belatedly discovered rules that will require employees to forfeit benefits promised to them by employers.

I would also like to say a few words about the cafeteria plan provisions presently contained in H.R. 4170. These provisions would accomplish two changes. First, cafeteria plans would not be allowed to include any nontaxable benefits other than those specifically covered by the Internal Revenue Code, such as medical and dependent care. The effect of this would be to prohibit including in cafeteria plans such fringe benefits as free parking and merchandise discounts, which are generally believed to be nontaxable but whose eventual tax status is controversial. Benefits of this type are not included in our member companies' plans and we have no objection to this provision.

Second, H.R. 4170 would prohibit employers from offering any taxable benefits in their cafeteria plans other than cash. The taxable benefits typically being offered in cafeteria plans are benefits such as life insurance for dependents, group automobile insurance, and financial planning services. These services are provided to employees by employers because the employer can obtain them at lower costs than could the individual employee. Because these benefits are by definition subject to taxation, we frankly cannot understand why Congress or anyone else would wish to exclude them from cafeteria plans. If we as employers can obtain a service from the market place at a lower cost than can our individual employees, and the employee is willing to pay tax on the value of the service, why should we be prohibited from doing so. Indeed, given Congress' concerns about revenue loss in the employee benefits area, one would expect Congress to welcome as many taxable options in cafeteria plans as possible.

The Employers Council is also deeply concerned about the proposals recently published by the Joint Committee on Taxation involving cash or deferred arrangements under Code section 401(k). Cash or deferred arrangements have been on the scene for over twenty years, but they have been subject to special rules under the Internal Revenue Code only since 1978. These plans permit employees to reduce cash compensation or other welfare benefits and to have the amount of the reduction contributed to a qualified profit sharing or stock bonus plan. Typically, these contributions accumulate under the Section 401(k) plan until the employee terminates employment or incurs a "hardship". Hardship distributions involve payments for extraordinary needs, such as major medical expenses, purchasing a primary residence, or paying a child's college expenses. When coupled with a cafeteria plan, a section 401(k) plan permits a three way choice for employees among cash, welfare benefits, and retirement benefits.

The Joint Committee has proposed three changes for section 401(k) plans: first, that hardship distributions be limited to "unforeseen" events; second, that the special nondiscrimination test under Section 401(k) be the sole method of measuring nondiscrimination under the plan; and third, that the cut-off point for determining who is "highly compensated" under a plan be modified to include only employees earning more than a specified dollar amount. In our view, these proposals are ill conceived and ill timed.

Limiting hardship distributions to "unforeseen" events would eliminate hardship distributions for home purchases and for payment of tuition expenses. This change would unfairly discriminate between section 401(k) plans and other types of qualified plans, is contrary to sound tax policy, and would hit hardest at the lower paid employees.

The need to purchase a home and to pay tuition have traditionally been treated as "hardships" under standard, nonelective profit sharing plans. The policy embodied in section 401(k) is that it is reasonable to treat elective employer contributions to a 401(k) plan the same as automatic employee contributions to a traditional profit sharing plan as long as participation in the plan is sufficiently widespread. The withdrawal restrictions presently included under section 401(k) (limiting distributions to termination of employment, death, disability, hardship, or attainment of age 59½) were added to prevent cash or deferred plans from benefiting only the highly compensated. If a cash or deferred plan, like the traditional profit sharing plan, had been able to distribute the contributions under the plan after they had been accumulated for as little as two years, there was fear that the lower paid employees would withdraw two-year-old contributions at the same time they were putting new contributions into the plan, resulting in no additional funds being set aside for the lower paid employees. See Halperin, "Cash or Deferred Profit-Sharing Plans and Cafeteria Plans", 41 N.Y.U. Tax Institute 39-22. Permitting distributions for home purchases and tuition payments does not raise these same policy concerns. These are extraordinary events, and are not so common as to cause the distributions for the lower paid to cancel out their contributions.

Eliminating hardship distributions for foreseeable events is also poor tax policy. While corporations typically provide benefits for sickness and disability, they do not have plans providing funds in cases of other types of hardship, such as the need to purchase a home because of a transfer or because of an increase in family size or circumstances. Given the high costs of housing and college education and that interest rates are still abnormally high, the corporate employee is particularly vulnerable to financial hardships. The corporate employee typically does not qualify for government aid such as tuition or mortgage assistance but finds it difficult to accumulate sufficient funds to obtain a mortgage or finance a dependent's education. Rather than eliminating such a socially desirable means of meeting with such financial obstacles, permitting hardship distributions for these kinds of events should be formally approved.

Focusing on the foreseeability of a particular expense would create artificial distinctions between different types of events. Why should the cardiac patient who is overweight and who smokes tobacco be treated more favorably than the employee who is forced to move to a larger house because another child is born into the family? Is not the focus better placed on whether the expense is a major item of expense that is unlikely to recur? What is to be gained by forcing the employee to terminate employment so that he can receive a distribution from his plan in order to make a down payment on a house or to send his child to college?

The proposed change in the hardship standard would strike the hardest at the lower paid employees. For a section 401(k) plan to pass the Code's nondiscrimination tests, substantial contributions must be made on behalf of the lower paid employees. These employees will be apt to stay out of the plan, however, if they do not have access to their funds for major expenses. Since section 401(k) plans generally involve some "matching contributions" by the employer, the lower paid employee stands to lose more than the tax savings on the contribution if he does not participate. The higher paid employee may be able to save for these expenses without the lure of matching contributions, but the lower paid employee may not.

Turning to the other points proposed by the Joint Committee, the Employers Council also feels that it is inappropriate to change the definition of highly compensated employees under section 401(k) or to outlaw reliance on the general nondiscrimination rules of section 401(a)(4) of the Code. The definition of "highly compensated" employees under section 401(k) is presently written to include the top one-third of eligible employees, and there is simply no evidence to indicate the need for any change at this time. No dollar amount was suggested in the Joint Committee's paper, but any dollar amount must be arbitrary in its effect given regional differences in pay levels. The top one-third rule was arrived at in 1978 after prolonged consideration, and it is premature to make any changes in the law without evidence of abuse.

It is also inappropriate to require that the special mechanical tests of section 401(k) (the so-called 1.5 and 2.5 tests) be the sole method for testing nondiscrimination under a cash or deferred plan. The adoption of this proposal would merely increase the paperwork and administrative costs for many employers. For example, many large companies have separate section 401(k) plans for salaried employees and for union employees. Since employees who collectively bargain for benefits can be excluded from plan coverage without jeopardizing plan qualification, many companies take the position that the separate plan for union employees automatically satisfies the rules of section 401(a)(4) without reliance on the special nondiscrimination rules of section 401(k). Requiring these companies to monitor compliance with the special tests of section 401(k) for union as well as non-union employees would only mean higher administrative costs, with no added benefits.

Requiring plans to meet the special mechanical tests of section 401(k) instead of the general rules of Section 401(a)(4) will also rule out integration of these benefits with Social Security. Again, this change would unfairly discriminate against section 401(k) plans as compared to traditional profit sharing plans. Under the well established rules on Social Security integration, an employer in effect gets credit, in testing discrimination, for the Social Security taxes that it pays on behalf of plan participants. Cash or deferred plans differ from traditional profit sharing plans only in the ability of the participant to decide his level of plan contribution. Why should the mere matter of employee choice result in so basic a difference in these plans?

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Mr. GIBBONS. Thank you, sir.

Our next witness is from Hewitt Associates, Susan Koralik.

STATEMENT OF SUSAN KORALIK, PARTNER, HEWITT ASSOCIATES

Ms. KORALIK. Good morning. My name is Susan Koralik and I am a partner with Hewitt Associates, a consulting firm that has assisted in the design and implementation of over 100 of these cafeteria plans that everyone is discussing this morning.

Because of our experience, we are very aware of the positive aspects of these programs, but we are also aware of the possibilities for abuse. We agree that some controls are needed and do not object to the amendments to section 125 that are recommended in H.R. 4170.

But, as Mr. Rogers pointed out, we too are very concerned about the recent IRS Information Release 84-22, 84-22 essentially addresses plans that have only one objective, tax avoidance. We agree that such plans have no substance and should not be allowed.

However, we disagree with where the line has been drawn between valid and invalid plans. Our objection is that the IRS has said that amounts available for reimbursement that are not used must be forfeited at year end. We do not think this use it or lose it concept is necessary or appropriate, and we strongly suggest that it not be imposed without Congress giving further thought to its impact on other worthwhile objectives.

Two common objectives, controlling health care costs and meeting the needs of the changing demographics of the work force, can be addressed through flexible programs. One of the biggest problems facing employers is the rising cost of medical care, and one contributing factor is duplicate medical coverage. About 40 percent of the families in the United States have two working adults and therefore have the potential for being covered by two medical insurance plans.

On the other hand, these two-worker families may have a need for dependent care, and only a handful of companies have agreed to add any dependent care benefits to their traditional benefit programs. But by using flexible compensation a number of companies are willing to substitute dependent care for health insurance.

Among the companies we have worked with, about 30 percent allow employees to trade of unneeded benefits for child care. Dependent care is a good example because it requires the use of a reimbursement account. Child care cannot be insured. There is no risk to be shared. Everybody knows whether or not they need child care and they can estimate the cost fairly accurately. So the reimbursement account concept is essential to providing child care benefits.

But reimbursement accounts can also be effective in providing benefits that have traditionally been insured. Let me give you a few examples. Xerox Corp., Alcoa, Quaker Oats, and B.F. Goodrich are among the companies that recently converted their rich medical plans with little or no cost-sharing to more modest plans with deductibles and copayments applying to all expenses.

To gain general employee acceptance and to successfully negotiate with their unions, these companies agreed to use most or all of the first year cost savings to establish a reimbursement account. The reimbursement account money can be used to pay for specified health care expenses, but the money also serves as an incentive. If the full amount is not spent on health care, the balance will be paid to the employee as a taxable cash payment at year end.

So this is not a salary reduction; this is a salary increase. Each year the company will establish a new account for the employee, so each year the employee has the security of having good protection, but also has the incentive to not over-utilize health care services.

Now, if the remaining amounts must be forfeited, the incentive is eliminated. In fact, employees would feel encouraged to spend the rest of the money.

In summary, we do not see the purpose of mandating that a plan include risk-sharing or the potential for forfeiture to provide that it has some economic substance. Other alternatives should be considered to differentiate between valid and invalid plans.

For example, the plans might require that the reimbursement account be established before the beginning of the year and not be changed, so it would eliminate the zebras that Mr. Halperin was referring to.

Also, there are nondiscrimination requirements in Internal Revenue Code Section 125 and other applicable Code sections that apply. These have not been interpreted by the IRS. We strongly encourage the IRS to issue regulations clarifying valid and invalid plans on this basis. If this is inadequate, a limit could be placed on the cash that could be elected in a flexible plan.

We have suggested these types of controls in numerous conversations and have prepared many papers for the Treasury and legislative staff since 1978, and we would be happy to continue to work toward a better solution.

Thank you.

[The prepared statement follows:]

STATEMENT OF SUSAN KORALIK, PARTNER, HEWITT ASSOCIATES

Good morning. My name is Susan Koralik and I am a Partner with Hewitt Associates, a consulting firm specializing in compensation and benefits.

Hewitt Associates assisted in the design and implementation of the first flexible compensation programs in the early 1970's. In the last 10 years, we have assisted over 100 employers in introducing flexible compensation arrangements.

Because of our experience, we are very aware of the positive aspects of these programs, but are also aware of the possibilities for abuse.

We agree that some controls are needed and over the last few years have offered suggestions to the Treasury staff and many legislators on how these programs could be regulated. As a result, we are very concerned about the recent discussions regarding flexible compensation, specifically the IRS Information Release 84-22.

IR 84-22 essentially addresses plans that have one objective—tax avoidance. The IRS described a plan that simply recharacterizes taxable compensation into nontaxable reimbursements for specific expenses. We agree that such plans have no substance and should not be allowed. However, the argument the IRS chose to attack these plans swept in almost all reimbursement accounts. We agree that a line has to be drawn between valid and invalid plans; we just disagree with where the line has been drawn.

The IRS has said that the amount available for reimbursement should be set before the beginning of the year. Most plans are already doing this and we believe others could adjust without much difficulty. However, the IRS has also said that amounts available for reimbursement that are not used must be forfeited at year-end. We don't think this "use-it-or-lose-it" concept makes sense.

(1) The impact of requiring forfeitures varies based on the type of expense covered under the account.

(2) Requiring forfeitures is counterproductive to the objective of controlling health care costs.

(3) We don't think forfeitures are necessary for a plan to have economic substance.

Let me explain our objections.

There are two common objectives behind most of the 100 flexible plans we have designed. About half of the plans are aimed at controlling benefit costs and virtually all the plans are aimed at meeting the needs of the changing demographics of the work force. Companies have been discovering that plans aimed at one of these objectives tend also to satisfy the second.

One of the biggest problems facing employers is the rising cost of medical care, and one contributing factor is duplicate medical coverage. About 40% of the families in the United States have two working adults and therefore have the potential for being covered by two medical insurance plans. Through typical coordination of benefit procedures, these families are assured of having 100% of their health care expenses paid. According to the study done by the Rand Corporation, these people are likely to use more medical services and incur higher costs than people who are asked to pay for part of the costs.

On the other hand, these two-worker families may have a need for dependent care. And only a handful of companies have agreed to add any dependent care benefits to their traditional benefit package. But by using flexible compensation, a number of companies are willing to substitute dependent care for health insurance. By cutting back on health insurance, the company is encouraging the employee to be a better consumer of health services. And by offering dependent care benefits, the company can attract new employees or help current employees with the cost of quality dependent care.

Among the companies we have worked with, about 30% allow employees to trade-off other unneeded benefits for child care. Of course, these plans typically allow for other trade-offs as well. But dependent care is a good example because it requires the use of a reimbursement account. Child care cannot be inured. There is no risk to be shared. Everyone knows whether or not they need child care and they can estimate the costs fairly accurately. So the reimbursement account concept is essential is providing child care benefits and the "use-it-or-lose-it" concept has little impact.

But reimbursement accounts can also be effective in providing benefits that have traditionally been insured. Let me give you an example.

Xerox Corporation recently converted its medical coverage. The old plan paid for 100% of the cost of hospitalization and required only modest cost sharing on other expenses. The company paid the full cost of the plan so there was no incentive for employees to be concerned with costs.

The new program, in contrast, requires the employee to share in the cost of hospitalization as well as other expenses and, for higher-paid employees, to pay a large share of the expense. Future increases in the cost of the coverage will also be shared with employees.

To gain general employee acceptance and to successfully negotiate with the union, Xerox agreed to use most of the first year cost savings to establish a reimbursement account. The reimbursement account money can be used to pay for deductibles and coinsurance or other specified health care expenses. But the money also serves as an incentive. If the full amount is not spent on health care, the balance will be paid to the employee as a taxable cash payment at year-end. Each year the company will establish a new account for the employee. So each year the employee has the security of good protection but also the incentive not to over-utilize health care services.

A similar plan had been negotiated between ALCOA and its 20,000 aluminum workers. BF Goodrich and Quaker Oats also have similar arrangements.

One criticism that has been offered is that these companies could have saved more money and made employees more conscious of health care costs by simply cutting back on the basic medical coverage without adding a reimbursement account. That's true. But these companies believe that there would have been a strike before the unions would have conceded that much. Obviously, these companies would like to cut medical costs as much as possible. But it would be short-sighted to look at only the first year savings.

By sharing the first year savings and gaining acceptance, these companies can project future savings. The new medical plans will go up in cost. However, the new plans will always cost less than what the old plans would have cost. And, although the companies have promised to provide a reimbursement account each year, there is no promise that the amount in the account will be increased.

The "use-it-or-lose-it" concept should be addressed here also. First, consider the impact on companies that have already introduced programs. These companies reached an agreement with their employees and unions based on an assumption that the money in the reimbursement account was nonforfeitable. It seems unfair to change these agreements in midstream.

Second, offering a medical care reimbursement acount with a cash payout at year-end supports the Rand study results. The Rand study indicated that people are more careful consumers of health services if they share in costs. By converting a rich medical plan to a more modest plan plus a reimbursement account, the company has converted part of what it used to spend to an amount which the employee sees as his own money. The employee is likely to be as thoughtful about spending these new dollars as the Rand study indicates he is about other money. However, if the employee is told that these dollars must be used for medical expenses or forfeited, the employee will have no reason not to spend the money.

In summary, we believe that reimbursement accounts can play a major role in meeting the newer benefit objectives of many companies—providing for the special needs of individuals and controlling costs. But we don't see the purpose of mandating that a plan include risk sharing or the potential for forfeiture to prove that it has economic substance. Other alternatives should be considered to differentiate beteween valid and invalid plans. For example, the plans might require that the reimbursement account be established before the beginning of the year and not be changed. Also, the nondiscrimination requirements of Internal Revenue Code Section 125 and other applicable code sections could apply. We strongly encourage the IRS to issue regulations clarifying valid and invalid plans on this basis. We also suggest that an end-of-the-year forfeiture requirement not be imposed without giving further thought to its impact on other worthwhile objectives.

Mr. PICKLE [presiding]. Does that complete your statement?

Ms. KORALIK. Yes, it does.

Mr. PICKLE. Thank you very much.

Now, the next witnesses will be Lloyd S. Kaye and Donald McKinnon, principals of William M. Mercer, Inc.

STATEMENT OF DONALD G. McKINNON AND LLOYD S. KAYE, PRINCIPALS, WILLIAM M. MERCER, INC.

Mr. McKINNON. Good afternoon. My name is Donald G. McKinnon. My colleague Lloyd Kaye and I would like to give shared testimony on cafeteria flexible spending plans. We are both principals with William M. Mercer, Inc., which advises over 5,000 employer clients in this country.

We at Mercer are aware of over 100 flexible spending plans now in effect, with hundreds more in the development stages. Why have these plans become so popular among the largest employers in this country, such as PepsiCo?

First, flexible spending plans provide all employees, regardless of pay level, with equal dollar amount to allocate for important needs, such as health care, child care, and personal legal services. In many cases, these socially important benefits would not be provided to employees without the flexible spending plan mechanism.

Second, the vast majority of employers who have adopted these arrangements did so in conjunction with major health plan modifications in order to reduce health care costs, both immediately and over the long term. Lower medical plan outlays by employers, as much as 30 percent lower for some of our clients, together with increased financial commitment by employees, reduces overutilization of health care facilities.

By having unused credits available as cash at the end of the year, the flexible spending account provides an incentive for employees to eliminate unnecessary health care consumption, an incentive otherwise missing in traditional medical plans. This is a vital tool in combating spiraling health care costs.

With proper limitations, these plans can accomplish the same desired results as tax cap legislation, in a manner far more acceptable to employers and their employees. Yet, with the hastily prepared information release 84-22, which came like a thunderbolt out of the blue after almost 5 years of refusing to provide employers any guidance in this area, the IRS intends to eliminate this vitally important employee benefit and penalize employers retroactively for making good faith interpretations of that law.

Mr. KAYE. My name is Lloyd S. Kaye and I am a principal with the consulting firm of William M. Mercer.

Mr. PICKLE. Mr. Kaye, will you pull the microphone down a little closer to you.

Mr. KAYE. Assistant Secretary Chapoton, appearing before the Senate Finance Committee last June, acknowledged the validity of flexible spending accounts, but stressed the importance for Congress to codify limits to prevent abuses. In fact, he offered an example of a plan that was far more aggressive than any we have ever seen, suggesting that it was legitimate under current law.

His analysis, added to the plain wording of section 125 and the 401(k) salary reduction precedent, set the stage for the dramatic increase in the adoption of flexible spending accounts by major corporations, advised by leading law firms. We know that our clients have acted in good faith to establish programs which grant equal benefits to all employees, regardless of pay level.

They are not designed as executive perquisites. There are strong motivations explaining why so many high caliber employers have adopted flexible spending accounts, but they have not been primarily motivated by the lure of tax avoidance, let alone evasion.

After more than 5 years of official silence, the IRS attack in IR 84-22 would destroy almost all flexible spending accounts on a retroactive as well as prospective basis. We believe this is unfair and misguided, in that their release concentrates on form and makes no distinction between plans that can be labeled abusive and those that are not.

We urge that at this point Congress assume control over this issue in one of two ways: First, immediately enact clarifying amendments. The present statutory framework already precludes discrimination in favor of higher paid employees. Explicit clarification is needed to prevent some employers from setting spending limits so high as to particularly favor higher paid employees.

We suggest that the setting of limits is all that is really needed to control abuses under section 125. On the other hand, if it is deemed desirable to study the issues over a more extended period, it is urged that Congress preclude the IRS from implementing its IR 84-22 and from issuing any proposed regulations, rulings, or announcements on section 125. Then we think you should begin deliberation on an open debate basis on the role and intent of code section 125 with an open mind, concentrating on substance and not form.

In conclusion, too much is at stake for employers and rank and file employees not to consider the issues in a perceptive and nonpunitive manner. Thank you.

[The prepared statement follows:]

STATEMENT OF DONALD G. MCKINNON AND LLOYD S. KAYE, PRINCIPALS OF WILLIAM M. MERCER, INC.

INTRODUCTION

William M. Mercer, Incorporated is an employee benefit and compensation consulting firm, with offices throughout the country serving over 5,000 clients. Many of our clients now sponsor a Cafeteria-Flexible Spending Account Plan, with more contemplating such a step.

BACKGROUND OF FLEXIBLE SPENDING ACCOUNTS

The wording of Code Section 125 states in substance that an employee participating in a Cafeteria Plan may choose between cash and a nontaxable benefit. An employee electing cash receives taxable income; an employee electing nontaxable benefits does not. Especially when read in the context of the recognition of salary reduction arrangements under Code Section 401(k), Code Section 125 fully supports the validity of a Flexible Spending Account or Reimbursement Account financed through voluntary salary reduction.

Under such an arrangement, each participating employee has the opportunity to forego a portion of salary in exchange for the employer's obligation to pay or reimburse the employee for nontaxable expenses such as medical care, dependent care and personal legal service. This is analogous to a permitted arrangement under Code Section 401(k) whereby an employee may voluntarily agree to an amount of salary reduction in consideration for the employer's obligation to pay that amount to a qualified profit-sharing plan which would not be subject to current taxation.

WHY HAVE FLEXIBLE SPENDING ACCOUNTS BECOME POPULAR

The last year has seen a dramatic increase in the adoption of Flexible Spending Account arrangements designed as Cafeteria Plans intended to comply with the standards codified in Code Section 125. This is a remarkable development, having occurred despite the absence of proposed regulations for over five years and the persistent refusal of the Internal Revenue Service to respond to hundreds of private ruling requests.

Especially striking is that the companies who have adopted such plans include many of the major corporations in the United States, advised by many of the most prestigious law firms. These corporations and their law firms have proceeded in good faith, believing that their interpretation of Code Section 125 was reasonable.

What has motivated usually-conservative corporations and law firms to proceed with implementation of Flexible Spending Accounts in the absence of explicit approval? Two overriding considerations are involved. First, Flexible Spending Accounts represent an easily-administered flexible program to provide all employees, regardless of pay level, with equal dollar amounts to allocate on a tax-effective basis for imporant needs pertaining to medical care, dependent care and personal legal services; and second, they are commonly designed in conjunction with amendments to medical reimbusement plans to reduce reimbursement levels. This second issue—containment of health care costs—is one of critical national concern. Many companies have taken major steps to reduce their tax-deductible outlays to medical care plans and have found Flexible Spending Accounts an important means to accomplish this.

Lower medical plan outlays by employers, and the assumption of heightened financial commitment by employees, reduces utilization of health care facilities. This is a vital step in reducing gross amounts spent for health care.

The issue of health care cost inflation is one which Congress will be addressing. The proposed tax cap legislation and the previous so-called pro-competition bills have the same objective—reduction in unnecessary and inflationary health care consumption. Hundreds of the largest employers in this country have implemented or are planning to implement flexible spending plans even in the face of regulatory uncertainty, with the same objective in mind. We believe Congress should not dismiss this approach casually. It is expected to accomplish the same desired result as tax cap legislation in a far more palatable manner.

Indeed, the Federal Employees' Health Benefit Program could be redesigned with a Flexible Spending Account in a manner acceptable to Federal employees and employee associations, and save the country millions of dollars.

THE IRS ATTACK ON FLEXIBLE SPENDING ACCOUNTS

The release of February 10, 1984 by the Internal Revenue Service (IR84-22) must be categorized as an unexpected thunderbolt. It would destroy the rationale of almost all Flexible Spending Accounts adopted in the last year or more. Moreover, it would do so on a retrospective basis, imposing financial hardship on employers and all participating employees.

The release makes no distinction between those plans which attempt to stretch the limits of the tax law in a discriminatory fashion particularly beneficial to higher-paid employees, and those adopted in good faith as plans which provide reasonably equal dollar availability to all employees regardless of pay level.

There is an important distinction here which should be recognized, i.e. the difference between plans that can be fairly called abusive and those that are not.

It is significant that in his testimony of June 22, 1983 to the Senate Finance Committee, Assistant Secretary Chapoton acknowledged the validity of Flexible Spending Accounts, but stressed the importance for Congress to codify limits to avoid abuses. In fact, Mr. Chapoton provided an example of a flexible spending plan that was far more aggressive than any we have seen to date, suggesting that such an arrangement would be legitimate under current law. It is unfortunate that IR84-22 ignores this testimony, which convinced many attorneys of the validity of the Flexible Spending Account concept when designed conservatively, and instead undermines a type of employee benefit program which so many leading corporations believed valid and beneficial. It is also unfortunate that the IRS failed to issue any guidance on Cafeteria Plans for over five years since Section 125 was added to the Code, persistently ignoring the requests of members of Congress, industry groups and individual employers to address this issue.

THE ISSUES OF IR84-22

Two key issues are raised by the recent IRS release (IR84-22):

(1) Should an employee's voluntary account be at "risk", i.e., salary reduction under a Cafeteria Plan must be elected before the beginning of the tax year, with amounts elected in advance subject to loss if not used in the tax year; and

(2) Should a distinction be made between pre-paid accounts (or "Benefit Banks") and zero-based accounts ("ZEBRAs"), two prevalent variations of the flexible spending plans, in terms of retroactive penalties and future viability?

RISK

A requirement of advance commitment involving risk of loss imposes the possiblity of severe hardship on lower-paid employees with limited resources and those who lack the necessary foresight and shrewdness to guess "right" in advance. The elimination of risk stimulates plan participation among these groups.

The wide proliferation of Flexible Spending Accounts among many major corporations is based on their simplicity. For employers, they are relatively easy to administer and explain to employees. They do not require elaborate and expensive data systems and coordination. For employees and employers the absence of risk if fundamental. Neither has an adverse interest in guessing "right" or "wrong".

BENEFIT BANKS AND ZEBRA'S

Flexible Spending Accounts generally assume one of two forms, which in some instances are combined.

Benefit Banks are those in which employees (and often employers) contribute money in advance, to be used for reimbursement during the year, with the year-end, unused balance returned or otherwise applied for the employee's benefit.

ZEBRA's (zero-based reimbursement accounts) involve no advance outlay by employees. When valid expense claims are submitted and approved, they are paid in lieu of salary. From a policy standpoint, ZEBRAs make participation easier for lower-paid employees, simply because their money need not be pre-paid.

Benefit Banks have a cosmetic advantage in that they entail on advance election by employees and the creation of a pre-paid account rather than the direct approach of payment of a tax-free reimbursement check instead of regular salary. Many employers have adopted Benefit Banks because they could be administered more readily by an outside administrator. However, the difference is only cosmetic; the economics of Benefit Banks do not differ from ZEBRAs.

In either case, the tax-free payments to or on behalf of employees would be the same. Accordingly, if the economies and tax impact are identical at the end of the tax year, logic demands that no tax law distinction be imposed.

In summary, flexible spending plans are proliferating because of their effectiveness in controlling spiralling health care costs and because many of the leading tax experts in this country have found them to be supported by law.

Further, these plans benefit all employees equally, and are not executive perquisites. With proper restrictions, these plans need not have an adverse impact on tax revenues.

PROPOSED SOLUTIONS

We recommend that Congress assume direct control over the overall issues in one of two ways.

Immediately enact clarifying amendments

The present statutory framework of Code Sections 125, and supporting Sections 105(h), 120 and 129, already preclude discrimination in favor of higher-paid employees. It should be confirmed that equal dollar amounts be required for all employees, unrelated to pay levels. More explicit clarification is needed to preclude some employers from setting such dollar limits so high as to grant higher-paid employees a greater opportunity to obtain the tax benefits afforded under a plan. Although many solutions are feasible, one would be a limit which cannot exceed the full pay of the lowest-paid plan participant.

In addition, the plan should not permit the inclusion of options which have no specific statutory exclusion. However, at the same time, the inclusions of Code Sections 124 (qualified transportation) and 127 (educational assistance) should be permitted under a statutory Cafeteria Plan.

If it should be decided that the principles described in IR84-22 must prevail, equity demands that they should be prospective. Accordingly, any restrictive legislation should be prospective; and further, should enable employers with existing plans sufficient time to conform to new standards. At least 180 days is suggested.

Declare a temporary moratorium

If it is deemed desirable to study the issues over a more-extended period, it is urged that Congress: Preclude the IRS from implementing its IR84-22; preclude the IRS from issuing any proposed regulations, rulings or announcements on Code Section 125; commence deliberation on an open debate basis on the role and intent of Code Section 125.

Mr. PICKLE. Thank you, Mr. Kaye.

Now we have one other witness and that is Mr. Robert Peters, manager of compensation and benefits of the Mobil Oil Corp. Mr. Peters.

STATEMENT OF ROBERT B. PETERS, MANAGER OF COMPENSATION AND BENEFITS, MOBIL OIL CORP., ON BEHALF OF THE ERISA INDUSTRY COMMITTEE [ERIC], ACCOMPANIED BY JOHN MILES EVANS, ESQ., OFFICE OF TAX COUNSEL, MOBIL OIL CORP.; AND JANICE M. GREGORY, LEGISLATIVE DIRECTOR, ERIC

Mr. PETERS. Thank you. My name is Robert B. Peters. I am the manager of compensation and benefits of Mobil Oil Corp.

I am appearing today on behalf of the ERISA Industry Committee, better known by its acronym, ERIC, an organization of over 100 major employers who maintain employee benefit and welfare plans for several million active and retired employees. I am accompanied by John Miles Evans, esquire, from Mobil's office of tax counsel.

My purpose is to respond to some of the proposals before the committee, including the chairman's proposed further freeze on the qualified plan COLA, miscellaneous proposals in the final section, pages 107 to 109 of the hearing pamphlet entitled "Proposals Relating to Tax Shelters and Other Tax-Motivated Transactions," and finally the proposal for dealing with so-called premature employer contributions to benefit plans as they may impact upon the funding of such benefits as life and health benefits.

Much has already been said about cafeteria plans, and ERIC would like to note that it is also concerned that the February 10 IRS press release on cafeteria plans has caused confusion and uncertainty, and we urge that the committee encourage the Internal Revenue Service to promptly issue more substantive guidance in a form suitable for public comment.

At the outset, I feel it is important for the committee to know that we have had barely a week to review and react to most of these proposals, proposals which if enacted could in my view have a profoundly negative impact upon retirement savings for the vast majority of our employees and especially for our lower paid employees.

As yet, we have seen no statutory language. All we have had to work with is the sketchiest of outlines. With all due respect to this committee, the nature and scope of the changes contemplated by the proposals listed above are far too sweeping and the probable results of their enactment potentially far too damaging for legislation to be undertaken precipitously and without the benefit of thorough study and review by concerned parties.

You, we, and tens of millions of our employees will all be better served by more deliberation and less haste, especially since, most importantly, the kinds of benefit plans maintained by ERIC employers are neither utilized nor administered as abusive tax shelters in any way.

No. 1, the proposed freeze on the qualified plan COLA should be rejected. TEFRA reduced the limits on benefits paid by defined benefit plans and on annual contributions to defined contribution plans. TEFRA also suspended the then existing cost of living adjustments, COLA's, until 1986 and conformed the private plan COLA to the social security COLA.

It has been proposed that the private plan, but not the social security, COLA be further delayed until 1988. It would be inappropriate to impose reductions in COLA's for private plans that are more severe and prolonged than those imposed on public plans such as social security, congressional, civil service, and military retirement plans.

Second, hardship withdrawals from cash and deferred arrangements, called CODA's—it is our experience that the single greatest deterrent to participation by employees in a tax-favored program of retirement savings through a CODA is the inaccessibility of the funds once contributed. This is especially true in the case of our lower paid employees.

We have been eagerly awaiting the promulgation of final regulations by the Treasury which might expand the availability of withdrawals under the hardship exception to include for our employees the purchase of a primary residence, the payment of children's educational expenses, as well as extraordinary medical or casualty expenses. We have felt that the ability to withdraw funds without penalty for major capital and other once in a lifetime expenses for employees would not in fact result in a major permanent depletion of savings in most cases, but the ability to withdraw is necessary psychologically to promote retirement savings by rank and file employees.

The proposed impediment to hardship withdrawals is clearly a step in the opposite direction.

Third, withdrawal of contributions: Reordering the sequence in which amounts are deemed withdrawn from qualified plans would take us even further in the wrong direction as far as our rank and file employees are concerned.

As you know, under present law an employee is treated as first withdrawing his own already taxed contributions to a plan. Only when his withdrawals exceed his aggregate contributions does he receive taxable income in the form of earnings on his account balance or employer contributions. The proposal would turn the normal ordering system up side down so that the employee's own already taxed contributions would come out last.

What was said before with regard to the proposed impediments to hardship withdrawals under a CODA applies equally here. What this committee must realize is that the burden of these proposals will fall hardest upon our lower paid employees, and it is this group for whom a qualified plan account will represent the primary, if not the only, savings vehicle.

Fourth, discrimination in fringe benefits and cash or deferred arrangements, CODA's. The proposals on pages 107 and 108 of the Joint Tax Committee pamphlet include several ill-defined references to revisions of the nondiscrimination rules applying to statutory fringe benefits, including qualified plans, group term life insurance, group legal services, dependent care assistance, and CODA's.

It is impossible to comment intelligently or effectively until the scope and purpose of these suggestions is clarified. For example, the proposals to adopt a flat dollar amount to identify the lower paid group for discrimination purposes would clearly represent a radical break with normal rules for testing discrimination. There is no indication what this dollar amount would be and it is thus impossible to tell whether the proposal would reduce or increase the amount which could be deferred in any particular plan. Whatever dollar level is chosen, however, it is clear that plans would be impacted differently depending upon the compensation mix in each plan.

Finally, the life insurance and health benefits that are funded through VEBA's are of great concern to us. I would like to turn just briefly to the proposal which deals with that, described as premature employer contributions to benefit plans, on pages 78 through 89 of the Joint Tax Committee pamphlet.

ERIC's concern here is that the zeal to curb abuses in the use of tax-exempt voluntary employee benefit associations, called VEBA's, to fund deferred compensation arrangements not undermine the existing security of nondiscriminatory group life and health benefits that exist for our retired employees.

Under current law an employee can deduct reasonable additions to a reserve for such benefits so long as the amount is actuarially determined on a reasonable basis. This has encouraged employers to make provision for such benefits by funding reserves established by an insurance carrier or set up within a VEBA.

The proposal would impose upon VEBA's specific significant new rules for funding and nondiscrimination purposes. Their effects are unclear.

In conclusion, may I stress the need for certainty and stability in the rules governing employee benefit plans. Changes in this area will affect tens of millions of our employees, many of whom have put a lifetime of savings into qualified plans and have made long-range plans based upon existing rules.

On their behalf as well as on the behalf of hundreds of plan administrators who are still trying to digest the recent changes made by TEFRA, I urge this committee to postpone any action on the proposals I have indicated without extensive further study and without the benefit of informed public comment on specific legislative language.

On behalf of ERIC, I wish to express my appreciation for the opportunity I have had to address the committee on these issues, which again are of such great importance to all the employees of our member companies.

Mr. Evans and I will be happy to answer any questions you may have.

[The prepared statement follows:]

STATEMENT OF ROBERT B. PETERS, MANAGER OF COMPENSATION AND BENEFITS, MOBIL OIL CORP.

My name is Robert B. Peters. I am the manager of Compensation and Benefits of Mobil Oil Corporation. I am appearing today on behalf of The ERISA Industry Committee (better known by its acronym "ERIC"), an organization of over one hundred major employers who maintain employee benefit and welfare plans for several million active and retired employees. I am accompanied by John Miles Evans, Esq., from Mobil's Office of Tax Counsel.

My purpose is to respond to some of the proposals before the Committee, including

(1) the Chairman's proposed further freeze on the qualified plan COLA;

(2) miscellaneous proposals in the final section of the hearing pamphlet "Proposals Relating to Tax Shelters and Other Tax-Motivated Transactions" (JCS-5-84) prepared by the staff of the Joint Committee on Taxation; and

(3) the proposals for dealing with so-called "premature" employer contributions to benefit plans, as they may impact upon the funding for such benefits as life and health benefits.

ERIC is also concerned that the February 10 IRS press release on cafeteria plans has caused confusion and uncertainty and urges that the Committee encourage the IRS to promptly issue more substantive guidance in a form suitable for public comment.

At the outset, I feel it is important for the Committee to know that we have had barely a week to review and react to most of these proposals—proposals which, if enacted, could, in my view, have a profoundly negative impact upon retirement saving, especially by lower-paid employees. As yet, we have seen no statutory language. All we have had to work with is the sketchiest of outlines.

Adoption of any proposal without more adequate public notice and participation would give rise to the same type of criticism, discontent, and deficient legislation as resulted from the enactment of the TEFRA employee benefit provisions.

I should also note that none of the employee benefit proposals will have any significant impact on the deficit; no significant revenue estimate has been attached to them.

With all due respect to this Committee, the nature and scope of the changes contemplated by the proposals listed above are far too sweeping, and the probable results of their enactment potentially far too damaging, for legislation to be undertaken precipitously and without the benefit of thorough study and review by concerned parties. You, we and millions of employees will all be better served by more deliberation and less haste especially since the kinds of benefit plans maintained by ERIC employers are neither utilized nor administered as abusive tax shelters.

None of the proposals in the benefits area, we might add, was included in the Administration's tax shelter proposals.

(1) THE PROPOSED FREEZE ON THE QUALIFIED PLAN COLA SHOULD BE REJECTED

TEFRA reduced the limits on benefits paid by defined benefit plans and on annual contributions to defined contribution plans. TEFRA also suspended then existing cost of living adjustments (COLAs) until 1986 and conformed the private plan COLA to the Social Security COLA. It has been proposed that the private plan (but not Social Security) COLA be further delayed until 1988. This proposed must be rejected.

The freeze will have no significant impact on the deficit; it is estimated to raise less than $50 million per year. In addition, it would be inappropriate to impose reductions in COLAs for private plans that are more severe and prolonged than those imposed on public plans such as Social Security and Congressional, Civil Service, and military retirement plans.

Continued delay of the COLA will affect middle income employees, who were not the focus of the TEFRA reductions, and who generally do not benefit from the nonqualified deferred compensation programs currently provided for top management.

Prolonged delay of the COLA would result in significant unfunded liabilities (some or all of which may be guaranteed by the PBGC) when the limits are increased and would result in "backloading" of benefits which ERISA was intended to prohibit.

(2) HARDSHIP WITHDRAWALS FROM CASH DEFERRED ARRANGEMENTS (CODA'S)

In our experience, the single greatest deterrent to participation by employees in a tax-favored program of retirement savings through a CODA is the inaccessibility of the funds once contributed. This is especially true in the case of lower-paid employees.

We have been eagerly awaiting the promulgation of final regulations by the Treasury which might expand the availability of withdrawals under the hardship exception to include the purchase of a primary residence and the payment of education expenses for dependents, as well as extraordinary medical and casualty expenses. We have felt that the ability to withdraw funds without penalty for major capital and other once-in-a-lifetime expenses for employees would not in fact result in a major permanent depletion of savings in most cases, but the ability to withdraw is necessary psychologically to promote retirement savings by rank-and-file employees.

The proposed impediment to hardship withdrawals on page 109 of the Joint Tax Committee pamphlet is a step in exactly the opposite direction. It hardly needs pointing out that there is no need for a stronger lock on an empty chest. The simple fact is that without reasonable access to the funds accumulated, it is extremely difficult to secure meaningful participation by rank-and-file employees in a program of retirement savings.

(3) WITHDRAWALS OF CONTRIBUTIONS

Restricting withdrawals of contributions and reordering the sequence in whcih amounts are deemed withdrawn from qualified plans would take us even further in the wrong direction as far as rank-and-file employees are concerned (page 109 of the Joint Tax Committee pamphlet).

Under present law, an employee is treated as first withdrawing his own after-tax contributions to a plan; only when his withdrawals exceed his aggregate contributions does he receive taxable income in the form of earnings on his account balance or employer contributions.

The proposal would turn the normal ordering upside-down so that the employee's own after-tax contributions would come out last. In other words, only after withdrawing earnings and employer's contributions—and paying taxes due on those amounts—would the employee be able to touch the first dollar of his own after-tax contributions. In addition to being taxable, the first amounts withdrawn would be subject to a 10% penalty tax if the employee were under age 59½ and not separated from service or disabled.

What was said before with regard to the proposed impediments to hardship withdrawals under a CODA applies equally here: limiting reasonable access to retirement savings positively discourages participation by employees in general and by lower-paid employees in particular. Where the plan concerned is a typical savings or thrift plan which provides for matching employer contributions, the proposed rules threaten to depress rank-and-file contributions enough to create a serious qualification problem.

What this Committee should realize is that the burden of these proposals will fall hardest upon lower-paid employees. It is this group which finds it most difficult to save and which has the most to lose from restrictions which put their savings beyond their reach in any circumstances short of a catastrophe. It is this group for whom a qualified plan account will represent the primary, if not the only, savings vehicle. It is this group which will have the most difficulty borrowing or making other financial arrangements to meet large and unusual expenses. Yet this is the group which will be most penalized if employees are now effectively to be denied resort to their own after-tax contributions to a qualified plan. It is they, not the highly compensated, who will have to resort instead to taxable withdrawals to meet immediate needs.

(4) DISCRIMINATION IN FRINGE BENEFITS AND CASH OR DEFERRED ARRANGEMENTS (CODA'S)

The proposals on pages 107 and 108 of the Joint Tax Committee pamphlet includes several ill-defined references to revision of the nondiscrimination rules applicable to statutory fringe benefits, including qualified plans, group term life insurance, group legal services, dependent care assistance, and CODAs. The proposals include uniform nondiscrimination rules, modification of certain exceptions for collective bargaining contracts, fixed dollar amounts for defining lower-paid employees for nondiscrimination purposes, and modification of the nondiscrimination tests for CODAs. It is impossible to comment intelligently or effectively until the scope and purpose of the suggestions is clarified.

Uniform nondiscrimination standards for all fringe benefits were proposed in 1977 and 1982. They should again be rejected. As with the prior proposals, the current suggestions are unclear and might not adequately recognize employee preferences, might drastically and adversely affect disability programs, might require revisions of life insurance programs, and might unfairly allocate costs and present compliance problems. The proposals might well preclude employers from adopting, for valid business reasons, different fringe benefit programs for different groups of employees.

The proposal to adopt a flat dollar amount to identify the lower-paid group for discrimination purposes would represent a radical break with normal rules for testing discrimination. There is no indication what this dollar amount would be, and it is thus impossible to tell whether the proposal would reduce or increase the amount which could be deferred by the higher-paid in any particular plan. Whatever dollar level is chosen, however, it is clear that plans would be impacted differently, depending upon the compensation mix in each plan. The compensation mix, in turn, will depend upon the industry, the nature of the employer's business, the geographical area and other variables.

Discrimination has historically been tested on a plan-by-plan basis by comparing the relative benefits of low- and high-paid employees based upon their actual compensation. The new test proposed, on the other hand, would ignore the actual compensation spectrum under the particular plan and, instead, would impose a single, country-wide dollar standard for identifying the lower-paid group in any plan, regardless of the multitude of factors which distinguish different groups of employees. ERIC opposes any modification of the long-standing discrimination tests which would ignore the demographics of an individual plan.

The proposal would also prohibit CODAs from relying on the general discrimination rules applicable to all qualified plans. By definition, however, CODAs are part of qualified profit-sharing or stock bonus plans and should not be considered to be discriminatory if they satisfy the general discrimination rules applicable to all qualified plans. The special nondiscrimination rules applicable to CODAs, which limit the amount higher-paid employees may contribute based upon the average amount contributed by the lower-paid two-thirds of all employees eligible to participate, were designed as a safe harbor to encourage CODAs, not as an exclusive test of discrimination.

(5) LEASED EMPLOYEE PROPOSALS

TEFRA's leased employee rules for qualified plans focused on perceived abuses principally in connection with professional corporations. No abuse has been suggested regarding major employers which frequently lease security guards, cleaning personnel, cafeteria employees, and others from independent contractors that may be major employers in their own right and generally provide fringe benefits for their own employees.

(6) LIFE AND HEALTH BENEFITS FUNDED THROUGH VEBA'S

Now I should like to turn briefly to the proposals which deal with what are described as "premature" employer contributions to benefit plans on page 78 through 89 of the Joint Tax Committee pamphlet.[1] EROC's concern here is that the zeal to curb abuses in the use of tax-exempt voluntary employee benefit associations ("VEBAs") to fund deferred compensation arrangements not undermine the security of nondiscriminatory group life and health benefits for retirees.

Under current law, an employer can deduct reasonable additions to a reserve for such benefits so long as the amount is actuarially determined on a reasonable basis. This has encouraged employers to make provision for such benefits by funding reserves established by an insurance carrier or set up within a VEBA.

The proposals would impose on VEBAs specific significant new rules for funding and nondiscrimination purposes. Their effects are unclear. It is uncertain if deductions for funding many arrangements would be diminished or accelerated.

In conclusion, let me stress the need for certainty and stability in the rules governing employee benefit plans. Changes in this area will affect millions of employees, many of whom have put a lifetime of savings into qualified plans and have made long-range plans based upon existing rules. On their behalf, as well as on behalf of hundreds of plan administrators who are still trying to digest the recent changes made by TEFRA, I urge this Committee to postpone any action on the proposals I have indicated without extensive further study and without the benefit of informed public comment on specific legislative language.

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[1] This proposal is related to the proposal regarding premature accruals of deductions on pages 67 through 69 of the pamphlet. Treasury testimony has clarified that proposal by restricting its application to provisions which set the timing of deductions, for example, section 404 relating to deductions for qualified plans. A similar exception is necessary for funding of VEBAs and section 404A foreign plans.

On behalf of ERIC, I wish to express my appreciation for the opportunity I have had to address the Committee on these issues which are of such great importance to the employees of our member companies.

Mr. Evans and I will be happy to try to answer any questions you may have.

Mr. PICKLE. Thank you, Mr. Peters. We appreciate your testimony and your entire statement and that of all the panelists' will be made a part of the record.

I notice, Mr. Peters, that you have with you this morning Mrs. Janice Gregory, who used to be on the Ways and Means Committee staff. Does she care to make any additional statement or is she willing to let your testimony rest by its own?

Mr. PETERS. We will ask her to respond to that, sir.

Ms. GREGORY. That is fine.

Mr. PICKLE. I thank all of you gentlemen. I was not here for all of the testimony, and I hoped I could have been, but I have been looking at some of your statements and listening to you carefully.

Now, this is a very serious matter for the Congress and I do not know whether or not it will be a part of this tax bill. It may be, Mr. Peters, as you indicated, that this ought to be handled at a different time. But it is of a great interest to the Congress and the American people and it has a great importance to the social security system because of the treatment or lack of treatment of some of these programs.

I do not know that I want to argue with any of you about it this morning, but I do want to ask two or three questions or make some observations. Mr. Kaye, the staff has given me a copy of a bulletin that you have put out stating as you did in your testimony, that containing health cost is a critical national concern, and I think we would all agree with that.

Now, I have a copy of the Mercer bulletin, in which you talk about funding through salary conversion. While the report explains in detail the tax savings from setting up one of these arrangements, it fails to mention containing health care costs even once.

Let me read you a paragraph:

> The employee thereby saves the federal income tax and social security tax on $300. The state income tax is also saved in most states. The key is that in every pay period the total compensation is unchanged. Only taxable pay decreases, while the take-home pay increases. Employees do not defer pay. They face no agonizing choice among different coverages, only an opportunity to make part of their pay non-taxable.

Now, when I read that—and there must be other testimony that can be put in balance to it—it would seem to me that your primary purpose is just to evade income taxes for your employees. And that is probably the base of most of the difficulty we are concerned about in this committee.

Do you want to respond to that observation?

Mr. KAYE. Yes. I think that, as Mr. Rogers has pointed out and as my colleague Mr. McKinnon has pointed out, virtually all of the flexible spending account arrangements that we have worked on have been in close coordination with the health care cost containment programs.

As a matter of fact, we emphasize to every employer thinking about flexible plans that they should not miss the opportunity to contain health care costs by making their health reimbursement plans less generous than they are, and in effect shifting to employees a part of the cost that would otherwise be paid for on a tax deductible basis by the employer.

Now, the company that does that does not necessarily produce an erosion of the tax base. To the extent that the company can deduct it, it is true that employees do get some tax relief. But I think, as both Mr. Rogers and Mr. McKinnon have pointed out, it would be very difficult to truly implement an effective health care cost containment program without a flexible spending account.

Mr. Pickle. Well, Mr. Kaye, you have criticized the IRS press release on flexible compensation. Now, here again it is my understanding that the key to the Service's position is that there has to be some economically substantial arrangement.

But let me read again, now, since you raise the question of flexible compensation, another passage from your January report. And I am going to read it again. It is going to sound very familiar to you:

> The employee thereby saves the federal income tax and social security tax on $300.

And you repeat again:

> The state income taxes are also saved in most states. The key is that in every pay period the total compensation is unchanged. Only taxable pay decreases, while the take-home pay increases. Employees do not defer pay. They face no agonizing choice among different coverages, only an opportunity to make part of their pay non-taxable.

Now, can you tell me what the substance of such an arrangement is, besides tax avoidance? You have emphasized very strongly that this is tax avoidance, and of course it is a tax avoidance. The Government has an interest in these kind of developments.

I do not need another long speech, but just briefly comment on my question. Is there something that you are really interested in more than tax avoidance?

Mr. Rogers. May I answer that, please?

Mr. Pickle. Yes. Are you Mr. Rogers?

Mr. Rogers. Yes.

Mr. Pickle. All right. Mr. Rogers, I have a question for you, too.

Mr. Rogers. I do not work for Mercer, so I am not sure exactly the context in which that bulletin was written. What I do know is that, as many companies have tried to step up to the issue of getting employees to accept higher deductibles and higher levels of coinsurance in their medical plans, they have had to sort through how they could communicate that to employees and make it palatable.

In fact, I could have the choice, for example, of providing an employee with first dollar coverage, as an employer on his behalf, and deduct that full expense and no compensation would ever be imputed to the employee. As an alternative, I could ask that employee to take on a higher level of personal risk and self-insurance—and if the first dollar coverage cost me a dollar to buy for that employee as an employee and I deducted it from my taxes, the higher deductible and coinsurance feature might cost me 75 cents.

I would then make available to that employee the other 25 cents, and if they incurred medical costs they would spend that and it would not be taxable. Alternatively, if they did not incur medical costs that would come back into the tax system as taxable compensation.

But from the employer's point of view, it is important that, as you transition employees from first dollar coverage to more participation in the cost of their medical plans, that you explain and communicate and sell it to them in a way that it is a positive development rather than a negative development.

Mr. Pickle. Well, how would you describe the growth of the 401(k) plans that are in operation now?

Mr. Rogers. How would I describe the growth?

Mr. Pickle. Yes. Are they growing?

Mr. Rogers. I think the growth has been very dramatic.

Mr. Pickle. Yes, it has been dramatic, has it not? Well, has this growth continued in spite of the fact that, as a result of the 1983 social security amendments, the amounts deferred must now be treated as wages for social security purposes? These plans have still grown, have they not?

Mr. Rogers. Yes, they have.

Mr. Pickle. Now, if that is so, is it not likely to assume that this growth is going to continue in a broad area as we go forward, signifying that it is a very critical problem for the Congress to balance between employees an employers?

These plans are growing now and they are going to get bigger, and therefore we need to find a better answer. I would think that that is the basis we ought to start from. Do you disagree with that?

Mr. Rogers. I think that through all of that there has to be a tradeoff. An important consideration, particularly in the health and welfare, and I think also in the pension area, is the question of whether the employer or the employee, in trying to design a benefit program or coverage for themselves that meets their individual needs, will spend the dollar.

I think 401(k) plans undoubtedly have helped private employers curtail the expansion of their pension plans in the United States, because employees are now taking on more responsibility for their own capital accumulation needs.

Mr. Pickle. Well, Mr. Rogers, I do not know the length of the Mercer report. If it is not too long, I would like to make it a part of the record, if you could submit it to us. Is that agreeable? I would like to see it. And I do not want to accuse you of concentrating solely on the avoidance of tax, but you put it in bold letters and you talk about it and you keep insisting that is the main thing you are selling.

Now, there has to be a compensation for it. And I am not saying you are any different than a lot of these other companies. But I keep pointing out to you that when that happens, then we, the Federal Government, lose a lot of revenue and the social security programs lose a lot of income.

Now, I want to see if I understand this. The Internal Revenue listed some guidelines that it says ought to be used. IRS lists the worst type of a plan and then the best type of a plan, and as I understand it, the worst plan is one where the employee at the end of the year lists his expenses and he deducts it from his salary and gets to pay tax on, say, $2,000 less in wages. The employer gets to deduct that amount as well.

If that happens, is it not true that there is no income and no social security taxes paid on the amount involved? Is that not what is happening in many cases?

Mr. KAYE. That is true, but that is the most extreme type of situation.

Mr. PICKLE. I know. There are a lot of those other extreme cases out there, and we are trying to tighten up because this is taking advantage of both the Government and the social security program.

Now, the IRS gave an example of the best plan, and said in effect that prior to the beginning of the year, if an employee is willing to reduce his salary by a certain amount, that at the end he can deduct that amount, but if he does not use the entire amount he does not get to deduct more than what his actual expenses were. And on the other hand, if he has more expenses than the previously set amount, he would not get that, either.

Now, that is the best plan, and I assume you do not like that plan; is that correct?

Mr. KAYE. I think that plan would destroy the whole concept, in that you just could not get especially the lower paid people to risk money ahead of time that they could lose.

Mr. PICKLE. Well, we had a provision in the social security bill last year that included contributions to 401(k)'s in the FICA base, but not in gross income. Suppose we go back to that approach. Would you all agree with that approach? Would anybody disagree with that?

Mr. CHIP. I would disagree. Mr. Chairman, the reason why 401——

Mr. PICKLE. Who are you, now?

Mr. CHIP. My name is Bill Chip and I am with the Employers Council.

Mr. PICKLE. Have you been identified before?

Mr. CHIP. Yes. I am on the list of witnesses.

Mr. PICKLE. Go right ahead.

Mr. CHIP. You asked about the phenomenal growth of 401(k) plans. That resulted because very many employees in this country either had no retirement income protection or had very little. In the case of medical coverage, fortunately, in this country almost every employee who works for a company of any size already has rather generous medical coverage from the employer. So the room for dramatic growth in tax-free medical coverage is not anywhere near what we saw in the case of tax-free retirement contributions.

In addition, when people put money into a 401(k) plan they are putting money aside for their retirement. When they pay social security tax, in another sense they are putting money aside for retirement. And if I remember correctly, a number of employers actually supported what you were trying to do, imposing social security tax on 401(k) plans, because a number of their older employees did not want to forfeit public retirement benefits in order to get private retirement benefits. They wanted them both.

In the case of medical care, these are benefits that no one has ever viewed as an alternative to retirement income. They are not subject to income or social security tax now, and if we were to tell employees that, if we give you any choices about how you receive your medical benefits, you are going to have to start paying taxes on them, you are basically taxing them twice and it would, as Mr. Kaye said, it would eliminate choice.

Mr. PICKLE. Does anybody else want to disagree with that? Ms. Munnell?

Ms. MUNNELL. No, I support that. My preference, of course, is to put an aggregate limit on the percentage of total compensation that can be paid in the form of tax deductible employee benefits.

I would think sir, you might want a progressive formula. Let's us say 25 percent of total compensation—that includes pensions—for the first $40,000, 15 for the next $40,000, and 5 percent thereafter.

Mr. PICKLE. Do any of you disagree with putting a limitation?

Mr. THOMAS. That includes pensions?

Ms. MUNNELL. Including pensions. And then any excess on that amount would be included in the employer's tax base for payroll tax purposes and the employee's tax base for payroll tax purposes and income tax purposes.

Mr. HALPERIN. Mr. Pickle, could I make a comment?

Mr. PICKLE. Yes, sir.

Mr. HALPERIN. I think most of the testimony from the people on my left was quite reasonable, and if I understand the distinction that they are making between what they would consider abusive cafeteria plans and ones that are not, they seem to be describing situations where the result of the program would be to reduce the amount of tax-free benefits rather than increase it.

And if one could find a way to limit it to that, it might make some sense, as opposed to the possibility which we are seeing in certain dependent care programs in which there are great increases.

I also want to say that another distinction between the so-called abusive programs as described by the Treasury and other plans that would seem to be good is that you have better lawyers in the good programs. There is no real difference in substance between a lot of them.

But I think that the difference in terms of the limit does make some sense, if it can be implemented. And as I said on page 8 of my testimony, the kind of medical plan that Mr. Rogers described I think is consistent with sound public policy.

But the question I would raise that they have not really answered is, What happens if you give the employee this account of $300 or $500 in a way in which it would be taxable no matter how they spent it? If your real goal is to decrease the amount of expenditures on medical expense, that would be more effective. They may be suggesting that it is harder to sell it if you do it that way but they have not really said it, and I wonder if that is what their position is—that if you tell the employee that if he takes a cheaper medical program he gets a taxable cash fund, it is harder to sell the program.

Now they are saying they have to give him a cash fund which could be taxable and could not be taxable, depending upon whether they spend it on medical expenses. If the goal is to cut down the amount you spend on medical expenses, that is sort of backwards. I wonder what their reaction would be.

Mr. PICKLE. Well, I will let some of you respond. I do not want to keep expanding on this question, because we have other members here.

I will come back to you, Ms. Koralik. Let me first see if other members have questions. Mr. Thomas, and then we will come back and comment if time permits.

Mr. THOMAS. Thank you, Mr. Chairman.

I probably will get to the question posed by Mr. Halperin as I inquire of you, and I am speaking to the far side of the table now. I have been involved with this in my former life a little bit—negotiating on fringe benefits. I did it for 5 years for the academic community. Believe me, it leaves me cold when you are telling me that the tax-free cash ability under a fringe benefits label is an inducement to hold down medical costs. At the time medical costs were building, one of the primary reasons they were going so high was because you folks as employers were not doing your job in negotiating with employees over fringe benefits. The fact that that money that was available, in part, created the problem.

So I appreciate your concern. It is a little belated. If you had been a little more serious in your negotiations with employees earlier, we would not now be in the situation that you have decided you are going to try to rectify by allowing cash benefits if they are the cheapest possible plan.

I guess my second reaction is, I just cannot believe that that kind of operation is going on under the general label of fringe benefits operation. I believe the reason we have provided this is as an incentive to make sure that there is at least a minimal protection in the health area, and that in the structuring of it we have provided a small incentive to do it. And you are now telling me that it has to be a tax-free incentive in addition.

Now, getting to Mr. Halperin's question. If you had a dollar limitation—well, first of all, give me your choices between an aggregate limitation or a specific itemization of what you can or cannot apply for, that is, a modified cafeteria plan or a requirement that a particular minimum amount be applied to a basic medical protection plan and then a smaller amount left over for employees.

Which of those two choices would be most preferable to you as employers?

Mr. CHIP. This is Bill Chip with the Employers Council.

Mr. THOMAS. Get closer to the mike. I cannot hear you at all.

Mr. CHIP. We had a meeting of our membership on Monday and we asked them this question, and we presented to them the issue you just raised, that there is a certain skittishness, that if you allow individual employees opportunities to convert nontaxable benefits to taxable cash and vice versa, that a lot of them, particularly the highly paid, might go the wrong way and end up getting more taxable benefits than perhaps you and other people might feel is really needed.

And we asked them the question you asked: If some change were necessary to convince Congress that that would not happen, what would they prefer? And among the options we considered—and I really cannot say that the entire business community is behind any of these, because in fact we do not think that this abuse exists. And certainly the IRS news release has pretty much eliminated such abuses as there were.

But among the things we considered were caps, stricter discrimination testing, which would make sure that the higher paid did not get more benefits than the lower paid. I think the rules under 125 are already fairly strict. The problem is that, without IRS regulations, a number of employers had taken very liberal interpretations of those rules.

But again, this would be something that is entirely within the power of the IRS to implement. It would be stricter discrimination rules than some employers are now using.

In terms of caps, we considered that perhaps the justification for allowing cash in a cafeteria plan is basically this: There are differences among employees. Employees who have dependents generally need more life insurance than people who have no dependents and nobody to leave insurance to. They need dependent care, whereas people who have no dependents do not need dependent care. And they generally need higher levels of medical insurance coverage.

And we thought that if Congress could determine what a reasonable amount of those benefits for a person with dependents would be and a reasonable amount for what a person without dependents would be, and simply allow enough cash in the cafeteria plan that the single person who did not need those richer benefits could opt out of them and get taxable cash instead, that most of our members would rather have a cap of that sort than the IRS news release, which is basically telling them not how much they can put in the plan, but how to design their plans.

Mr. THOMAS. That was precisely the dilemma I was faced with in negotiating a plan for the employees that I had the responsibility for. And to me the only answer for that is that clearly cafeteria plans discriminate against individuals with different lifestyles and needs. Why not offer a minimum package of basic medical protection and offer whatever dollar amount is negotiated in an IRA or a tax-deferred arrangement?

And for those individuals who feel they need the money now, whether it be for dental or vision or whatever else, they can pull it out at the end of the year and it is then taxable. For those who want to plan for a retirement program and have the ability to do so, they can leave it in. It provides dollars to people, but taxable dollars.

The idea of going beyond that and providing tax-free dollars as part of a cafeteria plan to me is just—frankly, I do not see how it is legal. I do not think that is an appropriate application of the intent of Congress under the law.

Now, is there any reaction in terms of a tax-sheltered annuity, for example, of a percentage above and beyond that which is used for the basic medical, and then let individuals spend it how they want at the end of the year in taxable income for medical needs or for any other purpose?

As long as it comes out on the taxable side, that does not bother me at all in terms of an arrangement. Was that discussion carried on?

Mr. CHIP. Some employers would be happy if the plans were permitted to take any unused cash and put them into a retirement-type program. I think our feeling was we could not understand why Congress would not want to encourage employees to take these funds in a taxable form.

The IRS news release deals with two issues. It says you cannot have zebras, and I should point out that only about 10 percent of the plans in the country come under that definition. You have to make elections in advance. The employer has to commit before the plan year begins a certain amount for the particular benefits.

They also require that any funds not used be forfeited. All that means to the employee is, if I have $500 in medical benefits, I had better use every single dollar before the end of the year for medical, even if it means going out and buying a $400 pair of eyeglasses on December 15.

Mr. THOMAS. I understand. But the other side of the coin in terms of tax-free cash is unacceptable as well. And I do not understand why the option is not made that the employee can either have it as taxable income or it can be utilized for programs under a cafeteria plan—as long as the taxable aspect is there.

I think the employee choice argument that you are making is still valid. Why do you need it tax-free under the fringe benefits?

Mr. CHIP. Under the current Internal Revenue Code, all medical expenses of an employee paid by his employer, through insurance or otherwise, are free of tax. Now, as Mr. Rogers said, you can offer them a $2,500 a year medical insurance policy that pays for everything or you can offer them a $2,000 insurance policy and a $500 benefit bank, or a $1,500 insurance policy and a $1,000 benefit bank, or any combination of the above.

The only difference is, if you offer them a benefit bank some of that money is bound to come out as taxable cash. Without that opportunity, all of that money is guaranteed to go into nontaxable benefits. So the taxable cash option can only be a revenue raiser, because the alternative is that everything has to be nontaxable.

Mr. THOMAS. Mr. Halperin, I assume the reason you went to a degree of specification as to what is available is because any kind of a cap that is put on in total dollars, really, if you allow this tax-free cash arrangement, is too great an incentive to take that approach and individuals would forego the opportunity to take specific types of medical protection that we thought we were trying to encourage in the first place. Is that correct?

Mr. HALPERIN. Well, I think the problem with that last statement from the witness is that it starts from the assumption that you start with the existing base, that you are never going to have a tax-free amount greater than what the employer was doing beforehand. And of course, that may be true in particular corporations, but it is certainly not universally true.

And also the fact that the employer sets up the amount before the beginning of the year, as opposed to doing the kind of thing that waits until the end. It is just a question of careful planning, as long as the amount can be unlimited.

So I think a lot of what they are suggesting over here is starting from a world in which they see a current amount going for tax-free benefits. They say why are you objecting? All we're going to do is get some people to take it taxable. Presumably that is not a problem if you can somehow define that starting point in a way that applies across the board, but that is not going to be easy. I think that is difficult.

And second, the employer is not paying the medical expenses when he says to the employee: You can have the $500 regardless of whether you are spending it on medical expenses or not. So there is a difference between that and an employer payment, which I think is significant and therefore I would not include tax-free reimbursements.

I have less trouble with it, as I said in my statement, if we somehow knew it was within the world in which I think they are describing, they are starting with an expensive program and cutting back. I am doubtful we can draft that, but if it can be done, fine.

Mr. THOMAS. My last question. Give me your objection to the aggregate totals.

Mr. HALPERIN. Do you mean just put a dollar limit on everything that can be provided?

Mr. THOMAS. Yes.

Mr. HALPERIN. I think certainly that is a reasonable second best solution if we basically want to view this as a kind of tax cut. All we are going to do is basically let you have a certain amount of tax-free income. We give it to investors in lots of ways and we are just going to cut the employees in on it. We do not care too much how they take it.

It is certainly less objectionable if the dollar limit can be applied. I think that is another way out of this dilemma.

Mr. THOMAS. The lower the dollar limit, the more the odds are it would go into the kind of programs that are most beneficial, rather than specifying those beneficial programs.

Mr. HALPERIN. I think if we have a fairly low dollar limit we have greater assurance that there is going to be across the board usage. And I think one of the problems with cafeteria plans, particularly in the case of dependent care, you hear of people who are excluding $20,000, $30,000 a year. Well, there is no way we intended that to happen.

Mr. THOMAS. Thank you, Mr. Chairman.

Mr. PICKLE. Well, if there are no other questions, let me thank the panel. I am going to proceed with the next panel. We have five other panels.

But before you leave, though, let me make an observation to you now. This committee is not trying to be difficult for you and your companies, because giving the cafeteria plans and choices is a very healthy thing for the employees.

But neither can Congress allow the continued erosion of the tax base. I think if we do not do something, there would be no limit to what you would do. Oh, there would be at some point because you know you cannot get away with murder. But you would just keeping going in that direction.

Now, we must get some balance to it. I do not know what the revenue loss is now, but it must be enormous. If it is 0.5 or 1 percent of payroll on the long term, 1 percent of wages is a bundle of money, billions, and we are not getting that revenue, and the tax base is just getting weaker and weaker.

So we have got to find some kind of answer. Maybe one thing we could do is to get some good estimates of the cost of these cafeteria programs. We do not really know what it amounts to, really. We have to guess. Would you not all agree that it would be helpful to the Congress and to the Treasury if we did have some good appropriate reporting language on these programs? Would anybody disagree with that?

[No response.]

Mr. PICKLE. On that note, then, let me thank you all. Thank you for your testimony.

Now, the next panel will consist of Mr. Frederick Hunt and Barry Schotz. If you would come forward and take your place.

Mr. Frederick Hunt and Barry Schotz, then Mr. Peter Hutchings, then Mr. R. B. Swanke, then the Wyatt Co., represented by Mr. Coupland and Mr. Donn and Mr. Askins, and then Mr. Russell E. Greenblatt.

Now, as you gentlemen take your seats I will identify you. Mr. Hunt represents the Society of Professional Benefit Administrators. Mr. Peter Hutchings represents the Association of Private Pension and Welfare Plans. Mr. Swanke I believe represents the Independent Business Association of Minnesota, Mr. Swanke.

Then Mr. Coupland, Mr. Don and Mr. Askins represent the Wyatt Co. and the White Motor Corp. of Cleveland, Ohio. And then Mr. Russell Greenblatt, Esq., representing himself, I guess, from Chicago, Ill.

I will ask, then, if it is agreeable to you gentlemen, that we receive the testimony from Mr. Hunt first, and then we will just go right down the list. Mr. Hunt.

STATEMENT OF FREDERICK D. HUNT, JR., EXECUTIVE DIRECTOR, SOCIETY OF PROFESSIONAL BENEFIT ADMINISTRATORS, ACCOMPANIED BY BARRY R. SCHOTZ, PRESIDENT, CREATIVE COMPENSATION, INC.

Mr. HUNT. Yes, Mr. Chairman. I am Mr. Frederick D. Hunt. I am executive director, and speaking on behalf of the Society of Professional Benefit Administrators. SPBA is the national association of independent third party contract benefit administration firms. It is estimated that one-third of all U.S. workers are covered by such firms.

This is probably unique testimony in this hearing in that our comments are not so much expressing opinions as correcting facts. I come to you with a bit of a guilty conscience about the VEBA sections of the Joint Committee on Taxation report and proposals. You see, much of the information which created that section originated with SPBA. Thus we feel a responsibility to correct inaccurate interpretations of our information.

There is a rumor that this committee has already made up its mind to accept this entire package of proposals as is and that what the witnesses say today will not have any effect.

Mr. PICKLE. Where did you pick up that rumor?

Mr. HUNT. From, among other places, I believe it is printed in the BNA tax report, the daily tax report. But also, I understand that the discussions with various staff have indicated the same thing.

Mr. PICKLE. I will pass on to the chairman your observations.

Mr. HUNT. That makes it all the more important that we point out the errors in which we may have inadvertently played a role.

The first error is the theory that reserves can somehow be equated with abuses. While over-reserving might be one of the possible symptoms of abuses, reserving is simply not the root of the problem or a controlling factor. We understand the aim of this measure is to curb high reserves for exotic types of benefits, not destroying the basic VEBA.

We recommend that, instead of the error of looking to reserving, the committee go directly after the abuses in specific types of benefits which you hope to eliminate.

The second error might be clerical. The report proposes a safe harbor for reserves equal to 50 percent of the average of the claims of the last 3 years. In our discussion with the joint committee staff, we had agreed that the figure 50 percent was probably livable. However, instead of 50 percent of past claims, it should have said 50 percent of the next year's total expected cost.

The current proposal as written would probably be financially irresponsible and would cause ruin to employers and employees. It would also bring about a significant revenue loss for the Treasury.

The third mistake relates to the use of the term "enrolled actuaries." Again, this may have also been a clerical error. The joint committee staff and we had bounced around the idea of some sort of certification requirement similar to the enrolled actuaries status described in ERISA.

However, we all agreed that the actual current enrolled actuary designation as used in ERISA would not be appropriate since the current enrolled actuary status applies only to pension plans. Most of these are primarily for health-related coverage. Also, most actuaries will tell you that health costs are far less predictable than pensions.

Also, in our discussions with the joint committee staff we all seemed to agree that the hundreds of administrators and others who have a long and responsible record for setting reserves should not suddenly be disenfranchised. Thus, if some sort of certification is going to be required for reserves, the new certification authority must extend to all of those who have proven themselves qualified.

As a sidelight, I might mention that SPBA members have reported that their plans which do use actuaries invariably have higher reserves, since the actuary wants to be sure that the plan does not go bankrupt. Thus, the net effect of requiring actuarial certification could well be even higher reserves than at present. This would mean a revenue loss to the Treasury both from the deductible higher reserves set by the actuaries and the deductible contributions to pay for the new actuarial cost.

The fourth error is a potential blockbuster. This report proposes to unilaterally revamp significant sections of ERISA and other employee benefits laws. As you know, regulatory authority for employee benefits is delegated by Congress coequally to the Department of Labor, the Pension Benefit Guarantee Corporation, and the Department of the Treasury. Authority is also delegated through several other laws to about a dozen other Government agencies.

In this proposal the Department of the Treasury seems to have usurped the authority of all the other branches of Government who have a legal responsibility on this matter. This kind of proposal to limit reserves of employee benefit plans would actually meet with fierce opposition from the other Government agencies.

Also, as you know, I know that Mr. Rostenkowski has just asked Mr. Rangel's subcommittee to hold hearings on PBGC's request and concerns about underreserving. So I know that this committee in a month will be hearing all of the problems, about underreserving, and today we are hearing about overreserving . . . often on some of the same kinds of plans.

Ironically, even the IRS seems to disagree with the proposal of its parent Department of the Treasury. The IRS has consistently encouraged and defended VEBA reserves for long-range stability. In fact, the IRS goes so far as to encourage that reserves be built up in good years so that the VEBA will be able to provide the benefits during hard times.

Thus, not only is the Department of the Treasury position in direct opposition to the views and authority of the other legal authorities; it also seems to be in opposition to what its own operating arm believes. And we have some technical advice memorandums with relevant paragraphs, if you would like.

I am a novice in the matter of congressional authority. However, I know that the Education and Labor Committee spends a great deal of time hearing about the problems of underreserving, and they work very hard to encourage fairness and stability in plans. It would seem that this legislation deserves at least the input and review of the other legally responsible Federal agencies and congressional committees.

I apologize for any part that we may have played in these errors in the interpretations. However, the sad fact is that the errors, clerical, or otherwise, have been made in the current draft. The current proposals would cause a significant revenue loss for the Treasury. They would not necessarily control the abuses you seek to curb. They would cause financial havoc to employers and employees, and they would lead to greater unemployment and a greater load on medicare, medicaid, and social security.

Also, if you abruptly and unilaterally were to change this present situation there would be chaos in the regulatory process.

We thank you for this opportunity to appear and we stand ready to answer any questions and assist this committee and other legal authorities to create a proposal which will achieve the goals we are seeking.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF FREDERICK D. HUNT, JR., EXECUTIVE DIRECTOR, SOCIETY OF PROFESSIONAL BENEFIT ADMINISTRATORS

Mr. Chairman, my name is Frederick D. Hunt, Jr. I am Executive Director of the Society of Professional Benefit Administrators (SPBA). SPBA is the national association of independent third party employee benefit plan administration firms. Our member firms function much like indepedent CPA or law firms . . . providing continuing out-of-house administration services to employee benefit plans. It is estimated that one-third of all U.S. workers are covered by plans administered by such firms.

All of that background is to say that SPBA provides the Committee with one of the largest and yet compact representatives of the ultimate "consumers" of employee benefits policy and regulation. Further, since SPBA members are independent of both the sponsors and beneficiaries of employee benefit plans, we have no vested interest to press or axe to grind. SPBA's goal—like yours—is to assure efficient and fair benefit programs.

Our testimony today will make the following points:

(1) SPBA joins you in opposing true "abuses" in VEBAs, but we decry the fact that there is no national policy or uniform concensus on what employee benefits should be and what they should provide. Since all employee benefits have Congressionally-mandated "tax motivations", there is no accurate measure of what is an "abuse" within the law. We see too much confusion and flip-flops.

(2) This Joint Committee on Taxation report is not an all-encompassing Administration proposal as you may have been misled to believe. This is simply a unilateral proposal from the Department of Treasury, and it does not acknowledge or include the legal responsibilities and concerns of the other government agencies with authority over employee benefits such as VEBAs. I think you will find that the other agencies feel just the opposite as the Treasury proposal.

(3) The VEBA proposals in this report will lower revenue to the Treasury, not provide the promised desired gains. We cannot imagine why the Department of Treasury would propose ideas which create a revenue loss, and without any other gains.

(4) The VEBA has a history of strong stable cost-efficient and responsible service for over half a century. By far, the most common use of the VEBA is for basic health, disability, and/or pension coverage for average employees. To cripple this proven cost-effective insurance vehicle would cause untold human and financial suffering to millions of working families. This proposal would also tend to further overland the Social Security and Medicare/Medicaid system . . . both of these losses, of course, would lose revenue.

(5) The proposals in the middle of page 87 of the Joint Committee on Taxation Report relating to allowable reserves of 50% of a three year average of claims (only), is an inaccurate interpretation of information which SPBA provided to the Joint Committee staff. It makes a very big difference . . . 50% of what. The current inacurrate Treasury proposal is significantly under the minimum requirements most Insurance Commissioners set for the same kinds of coverage. The proposal would also cause great concern at the U.S. Department of Labor Office of Pension and Welfare Benefit Programs and at the Pension Benefit Guaranty Corporation . . . both of whom have the Congressionally-mandated responsibility for safety and stability of the plans.

(6) The reference to "enrolled actuaries" in the middle of page 87 is inaccurate and would be condemned as professionally unethical. Enrolled Actuary status, by Federal law, only applies to pension reserves. Since most VEBAs are all or primarily non-pension benefits, this would be disasterous. This provision also ignores and disenfranchises the hundreds of professional plan administrators who have over 50 years of experience and success in setting the reserves in VEBAs. Also, SPBA members report that plans which use actuarial certification of reserves tend to have higher reserves . . . which, again, means that the Treasury proposal would tend to raise the level of reserves and raise the expenses of the plan (to pay actuaries) . . . thus raising the tax deductions for the employer and lowering revenue.

Are there instances of plans and people abusing the employee benefits portions of the tax code to minimize their taxes? Yes! However, we must also remember that the decision of what is an "abuse" is purely subjective, since virtually all employee benefits policy is "tax-motivated", and even the most simple and basic benefits could be considered "abuses".

Having said that, I should point out that our SPBA members have long been the most vociferous opponents of financial finagling in the guise of employee benefits. Why? Because the vast majority of the workers covered by plans administered by SPBA members are plumbers, carpenters, secretaries, and lower-paid workers. These workers rely on their employee benefits as the basic part of their safety net of life. Thus, when a few bad apples move in for a quick buck . . . the aftermath must be borne by the average working man and woman of this nation. I am afraid that the Department of Treasury proposals are inadvertently an example of that destructive pattern, which will hurt the average worker far more than the few bad apples. Also, this proposal would lose revenue for the Treasury.

We are distressed that Voluntary Employee Benefit Plans (VEBAs) described in IRC section 501(c)(9) are now being lumped into the broad category of being "abuses". That is an unfair label. VEBAs have over 55 years of smooth and stable economical service to employers and workers. In recent years, as the costs for employee benefits rose astronomically, more and more employers have turned to VEBAs as the only cost-effective way to provide benefits for their workers. Basic health insurance is by far the most common benefit provided by VEBAs. I should also point out that even the health insurance companies, who might appear to be the "competitors" or the displaced providers of health insurance coverage, have seen the value of VEBAs, and many offer services to such plans on an administrative services only (ASO) basis.

Thus, there is a proven need for cost-effective health care coverage for workers of all income levels. Interestingly, the Treasury has also gained from this trend. Because employers using VEBAs can provide benefits on a cost-effective basis . . . the "business deductions" for employer contributions are much lower than they would be without a healthy system of VEBAs. Thus, VEBAs provide a needed service and present a revenue gain for the Treasury over alternative options.

VEBAs are also playing a useful role in our changing society. With the rise of two-earner families, VEBAs have tended to be more flexible, to try to provide an equal share of benefits to both workers . . . rather than a useless overlap of the same coverages. I have heard some uninformed people call that kind of efficient flexibility (which is especially valuable for working women) an abuse. I think the working women would disagree.

While the expressed purpose of the Department of Treasury proposal is not to wipe out VEBAs, it combined with continuous regulatory nibbling by IRS, does threaten to cripple the VEBA concept needed by millions upon millions of workers and their dependents . . . in order to crack down on a relatively few people who have stretched the intent of the 501(c)(9) section of the IRC. In other words, we beg you not to throw out the baby with the bath water.

While condemning those who truly have abused the 501(c)(9) VEBA option, I should make two points in their defense. First, that the instability of the times . . . constant news that Social Security, Medicare, and huge corporations are in trouble, and that deficits and unemployment are at sky-high levels . . . encourage a protective feeling of "grab your benefits and security while you can". Even the IRS, itself, goes to great lengths to condone legal ways to minimize taxes. Thus, the "abusers" could legitimately say that they are following that IRS advice, and they are providing for their future in order to lessen the burden on Social Security and Medicare. This may not be an evil in our system . . . just a manifestation of the traditional American determination to take care of one's family and be self-sufficient. Thus, the economic environment and a history of uncoordinated and contradictory regulation encourages this state of mind.

Also, it is important to realize that Congress and the agencies need to accept some of the blame for the spread of "abuses" into the VEBAs. When my members complain about "abuses" in the VEBAs . . . they invariably report the rapid rise of abuses can be directly traced to TEFRA. When you nipped the top-heavy plans, those who had "abusive" ideas in mind looked elsehwere . . . and they found 501(c)(9) VEBAs. If you wipe out "abuses" in VEBAs . . . they will turn up somewhere else. In fact, I even heard one scheme that somehow involved U.S. Savings Bonds. Will we be sitting here next year considering whether Savings Bonds should be curtailed because they are "tax-motivated"?

Thus, our first message was not to throw out the VEBA baby with the dirty bath water of abuses. Our second message is that the Congress and agencies should treat the disease . . . not scamper after every symptom. Make no mistake. We are not defending true abuses. In fact, we are saying that you should fight it with a cannon . . . not a shotgun. If there are "abuses" which are outside of the law, then IRS and the Department of Labor should pursue aggressive enforcement.

Addressing the proposal itself! For the sake of the record, I think we should take note that it has been incorrectly presented. It is not "the" Administration Proposals. It is simply proposals from the Department of Treasury. To the best of my knowledge the other Departments and agencies who have legal jurisdiction have not had formal input or given careful approval to the proposals you have before you. As you gentlemen know, the Congress has carefully delegated co-equal authority over employee benefit plans to the Department of Labor, Department of Treasury, and the Pension Benefit Guaranty Corporation (PBGC). Still other statutes give overlapping authority to dozens of other agencies such as the Department of Health &

Human Services and the Equal Employment Opportunity Commission, etc. Thus, this report and proposal represent only a very small percent of the total Administration and executive agency overview of employee benefits. I know that the agencies would violently disagree with most of these employee benefit proposals.

The clarification that this is simply a revenue document is not a criticism of the Joint Committee on Taxation staff or the Department of Treasury. In fact, we are used to each of the dozens of agenices and hundreds of sub-offices thinking and acting on each issue as if they were the one and only office with authority. In fact, that is a real problem. Quite often, an agency, such as the IRS will tell plans or administrators to do one thing . . . because their primary interest is in collecting revenue. Meanwhile the Department of Labor, whose primary interest is the safety and stability of plans and benefits, says that they will prosecute anyone who does what the other agency directs.

Meanwhile, I know that you are constantly pressed by the Pension Benefit Guaranty Corporation (PBGC) about their worry over insufficient plan reserves. So, two of the legally-responsible Federal agencies decry the problem of underfunding . . . while the Department of Treasury purports to represent all of them and says that there is too much funding. The Treasury has obviously not provided you with a balanced view.

I know it sounds funny to describe that kind of Catch 22 here . . . but it is a confusing and expensive dilema for the benefit plans, administrators, and employers. Since every agency eventually says, "Well, Congress mandated it," as their excuse for regulations . . . most Americans incorrectlay assume that you all are to blame. Thus, we want you to know that to act on this small report would simply exacerbate the confusion.

On page 86 of the report, under "Issues", the second paragraph says, "First, the Committee may wish to consider to what extent favorable tax treatment of employer contributions to welfare benefit plans, relative to payments for wages and salaries, is appropriate in view of the favorable tax treatement also provided when the employees receive the benefits." We agree wholeheartedly. Employers, employees, plans, administrators, and consultants have suffered in recent years from an abrupt reversal of policy. For almsot half a century, the Government encouraged more and better health and pension benefits for employees. In tandem, the Congress provided more and more government benefits for its own workers and for those covered by government programs, such as Social Security and Medicare. Thus, as plan sponsors yourselves, you have seen first-hand with your Social Security and Medicare plans what happens when there is insufficient reserves. You are now the veterans of that uncomfortable situation. Please don't mandate that every employer and employee with a VEBA repeat that sad experience.

About 1979, the costs of these constantly-improving benefits began to be felt. All of a sudden, instead of being a virtue for employers to provide maximum care and future benefits for employees . . . the employers and plan sponsors were being condemned for being too generous to their employees. There are a lot of people . . . both employers and workers . . . who are very mad and confused. I know that you feel the heat over proposed Social Security cuts . . . so imagine the complaints plans and adminstrators endure when you suggest even tougher cuts for private plans. This report is correct that Congress must consider what it wants national policy to be on employee benefits. There is no national policy, or even rough framework of cooperation and coordination of policy and aims. By all means, do undertake this . . . but remember that this current report is a mere first tiny step in that direction. If there is a fair uniform policy on employee benefits. I think you will find that the "abuses" and the state of mind which spawns them will dwindle. You will also find that revenues and compliance will be up and enforcement costs down.

I am purposely not delving deeply into the technical aspects of the proposals. We are fortunate that two other witnesses are here today with far better hands-on technical experience . . . Mr. Robert Swanke, on behalf of the Independent Business Association of Minnesota and Mr. Barry Shotz, on behalf of Creative Compensation, Inc. I might add that while both are testifying on behalf of other groups, both happen to be members of SPBA, and we endorse their comments and suggestions.

I do feel the responsibility to correct one particular error in the report/proposal, however. I feel responsible, because the proposal in the middle of page 87 of the report, which would give a safe harbor for reserves equal to 50% could probably be acceptable . . . but as I told the Joint Committee on Taxation staff . . . it makes a big difference 50% of what. The current proposal would mandate reserves that are well below the minimum safe levels which most Insurance Commissioners require for the same types of coverage. Thus, what you may be mandating is that plans go belly-up . . . and unhappy constituents with unpaid medical bills or lacking promised disability payments and pensions would come straight to Congress with their complaints. It would also mean that these people would suddenly be thrust onto the Social Security and Medicare/Medicaid rolls . . . which would cost even more. Thus, this Treasury proposal would be a social and revenue loss . . . not a gain.

There is another glaring error in the middle of page 87. The proposal casually mentions that an Enrolled Actuary certification might be used to authorize higher reserves. This is both foolish and professionally unethical. As you gentlemen well know, the Enrolled Actuary certification was created in ERISA for pension reserves. Enrolled Actuaries know little or nothing about health benefits. . . .which we must remember are the basis for most VEBA plans. Thus, it would be like having a chiropractor mandated to perform brain surgery. I might add that making actuarial projections for health costs is a much less precise science, than setting reserves for pensions and life insurance. In fact, in a survey of our members, we found that the plans that have used actuaries for setting reserves of health plans tend to be substantially over reserved. Thus, requiring an actuarial statement may well have the net effect of a Treasury revenue loss, because actuaries would tend to require a higher reserve than is now being contributed by the employer and deducted as a business expense.

Adding insult to injury, there just aren't a lot of actuaries who practice in the area of health reserves . . . especially if those who perform only for insurance companies are not counted. Also, the actuarial profession has very strict standards of proficiency. The arch sin in that profession if for someone who is not provably skilled in one area of reserve-setting to delve into another area (as would be necessary by this requirement).

I am not talking through my hat on the subject of actuaries. I worked for 3½ years with the actuarial profession and was on the front line of many of these same arguments. Also, I have more recently floated the idea with representatives of the actuarial profession, and they tend to agree. I also understand that well-respected actuaries have talked with the Joint Committee on Taxation staff and condemned this proposal.

Finally, this proposal . . . while it would provide a windfall of new income (at the expense of the benefit plans) for my actuarial friends, it would ignore the fact that there are hundreds of people out there . . . such as our SPBA members . . . who have been responsibly and competently setting reserves in this area for decades. Any proposal must be open to these people and their successors who have a proven record. The Treasury proposal would mandate reserve-setting by the very group who are least able to do the job . . . and disenfranchise the administrators and trustees who have a long and successful record in this area.

Also, actuaries aren't cheap. Employer contributions will have to be increased to pay for these new mandated actuarial services . . . and of course that means higher tax deductions by the employers and another revenue loss which the Treasury is proposing.

Finally, all of this brings us to the mystery of how and why this report/proposal clings to the hypothesis that abuses could be equated with reserves. It is incorrect and counter-productive. When Treasury and Congressional staff mention "abuses" . . . they invariably mention yachts, ski lodges, and other exotic benefits which they feel are being hidden in 501(c)(9) VEBAs. Our members agree wholeheartedly . . . so go after the exotic benefits . . . don't try to destroy the only cost-effective (cost-effective for both employers and the Treasury) means of being sure that the average worker can get needed basic health care!

I know that the question of what fringes are taxable has been a hot potato for a long time. However, I think that if the Congress and the Treasury take a position and deny ski lodges, yachts, et cetera . . . there is no need for this discussion of crippling the health, disability, and basic pension benefits of so many Americans. The current proposal is ineffective in achieving the ends desired. There is nothing in the proposal which would prevent a shrewd "abuser" from continuing to fund his ski lodge or yacht somehow. Use a cannon to destroy what you want to destroy . . . don't maim lots of innocent bystanders by wildly firing a shotgun.

Finally, while I know that the Congress purposely does not get into the nitty gritty provisions that are covered by regulations . . . the employee benefits field, which is regulated by dozens of overlapping agencies and hundreds of sub-agencies and departments needs greater detailed direction and Congressional intent. I am afraid that regulations have often been created in a capricious manner . . . or even worse . . . a contradictory manner by different agencies on the same point.

Thus, in summary, I would make the following points:

(1) SPBA joins you in opposing true "abuses", but decries the fact that there is no national policy or consensus to define what an "abuse" is.

(2) This is not an all-encompassing Administration proposal as you have been misled to believe. This is solely ideas from the Department of Treasury, which is only one of many Government agencies who have regulatory authority over this issue.

(3) Ironically, implementing these proposals would lose millions of dollars of revenue for the country, because implementation would raise the business deductions of employers and reduced benefits would lower the income tax base and raise the Medicare/Medicaid and Social Security costs.

(4) Besides costing the government dollars, these proposals would also cost untold amounts of hardship and financial ruin for American working families. The worker whose VEBA health plan goes bankrupt (by Congressional mandate) himself goes into bankruptcy trying personally paying the health bills. Obviously, that worker then pays no income taxes, and also probably becomes a burden on the Medicare/Medicaid and/or Social Security system. Thus, in the name of raising revenue . . . the Treasury proposal would destroy the life of thousands of families and also destroy the normal tax revenue which those families would generate.

(5) The suggestions made on page 87 of the report relating to a 50 percent reserve level and/or requiring an enrolled actuary are technically inaccurate, and do not recognize the proven skill of those currently selling reserves. Again, this section of the proposal would produce a revenue loss.

(6) Again and again, I have to say that we need a uniform national policy on employee benefits. I speak not only for SPBA and for our sister associations in the insurance/benefits field . . . but also for dozens of top-level IRS, Department of Labor, and Department of Health & Human Services and other officials who are frustrated and concerned about the aimless wandering and nitpicking at the edges of employee benefits such as this Treasury proposal.

If you want to consider a comprehensive review of insurance and benefits . . . including all of the hundreds of relevant state and federal government entities . . . SPBA will be first in the line to volunteer to help. As I noted in my opening remarks, it is estimated that ⅓ of all U.S. workers are covered by plans administered by firms such as SPBA members, so we are probably the most comprehensive and yet compact representatives of the benefits industry . . . and because we are *independent* administrators, we have no vested interests or axes or grind. We, like you, want the most efficient and cost-effective benefits policy. The current disarray is a significant handicap to everyone . . . and an ill-conceived proposal such as this one from the Department of Treasury, which would actually create human and revenue losses (not the desired gains) is unwise and ill-conceived for its lack of coordination with the other required agencies. I know that the Congress is very busy . . . so let me nominate the VEBA portions of this proposal for the trash can, so that you can move on to more productive matters.

Mr. PICKLE. Thank you, Mr. Hunt.

[Mr. Schotz submitted the following:]

SUBMITTED BY BARRY R. SCHOTZ, PRESIDENT, CREATIVE COMPENSATION, INC.

WHAT IS A VEBA

A VEBA (Voluntary Employees' Benefit Association) is, as the name implies, a trust to fund employee benefits. It is subject to the Regulations covering IRC § 501(c)(9). Permissible benefits are life, sick, accident, and other related benefits. Pensions or deferred compensation are not permissible. The Regulations also dictate that "no part of the net earnings of the organization inures, other than by payment of the benefits . . ., to the benefit of any private shareholder or individual". The Regulations state that benefits must be provided on an equal basis to all similarly situated employees, and may not disproportionately favor the highly compensated.

These programs are also subject to the reporting, disclosure, and fiduciary standards provisions of ERISA.

Contributions to the trust are irrevocably committed to the payment of employee benefits. This money can never be used for anything but employee benefits. The funds no longer belong to the employer, but to the trust, out of the employer's control. If the program's application to the IRS is approved (i.e., the program adheres strictly to the Regulations), the earnings of the trust are exempt of tax. If the contributions are made on an actuarially sound basis and are reasonable, the contributions are deductible under Section 162.

The abuses of VEBAs by professional corporations (referred to as "limited membership plans") since the passing of VEBA Regulations in 1980 has resulted in justifiable concern, leading to the considering of VEBAs along with abusive tax shelters. This approach is understandable but is nonetheless based on a fundamental misconception regarding the broader, more traditional use of VEBAs by employers.

Since 1954 many companies across the country have used VEBAs to provide security for the long-term funding of basic employee benefits. The Internal Revenue Service has stated the permissible economic and social purposes of the VEBA under the 501(c)(9) Code and Regulations. A National Office Technical Memorandum clearly defines this area. "There are many valid purposes for which a 501(c)(9) may accumulate reserve funds. The existence of reserves allows such an organization to conduct its activities without interruption during financially adverse periods, such as, for example, strikes, lock-outs, and economic recession. Normally, as is the case here, the voluntary employees' beneficiary association is almost totally dependent on employer contributions for its funds. Therefore it would of necessity be forced to suspend or substantially reduce its operations if those contributions were to be totally cut off or substantially reduced unless it retained a reasonably large reserve fund."

Referring to a long-term disability benefit provided by a VEBA the TAM states further "It is prudent to attempt to fund such future liabilities in the early years of the plan's operation, rather than risk the possibility that the plan may be underfunded in future years . . . ." LTR 8309004 National Office Technical Advice Memorandum. See Exhibit I.

This language gets right to the heart of the function of a VEBA. A VEBA is a rainy day fund for protection of the funding of the employee's basic benefits, which often amounts to 35–40% of a company's payroll.

When a company experiences financial difficulty (such as occurred on a large scale during the recent downturn in the economy) the first employees to be terminated are the rank and file. These are also the most likely employees to use unemployment insurance and other state and federally funded welfare benefits.

The effect of crippling VEBAs would be to undermine the private sector's ability to pay these benefits and in the long run erode the federal tax base. A VEBA is a company's only vehicle for building the reserves necessary to survive economic downturn and increased costs in benefits. To deny this to American business is to insure another wave of business closures in our next recession with the inevitable resulting increase in unemployment and federally funded welfare expenses. The final result is a seriously weakened tax base, a demoralized work force, and an increase in government costs in welfare benefits.

To paint VEBAs of this kind with the same brush as the abusive VEBAs of small professional corporations would be a great mistake.

Following are specific recommendations aimed at curbing the abuses occurring in VEBAs. These recommendations are based on 12 years of practical experience in VEBA design for companies ranging in size from 2 employees to nearly 100,000 employees. Many of these are provisions we have been recommending to the Exempt Organizations Section of the IRS for years; and have been standard language in many of the VEBAs designed by our firm.

PERCEIVED CURRENT ABUSES BY LIMITED MEMBERSHIP (PROFESSIONAL CORPORATION) SPONSORED VEBA'S

1. Substituting VEBA's for qualified retirement plans

The dissolution and distribution of the assets of the VEBA should be done on an actuarially determined basis. The attached dissolution section, which many of our clients have used successfully with the Internal Revenue Service, should provide adequate guidelines for controlling this abuse. It provides for all of the employees to receive their actuarially determined amounts attributable to each one of the benefits provided by the VEBA. This section also prevents the employer from terminating the employees first and then terminating the VEBA to receive the funds. Along with this dissolution section should go the prohibition against providing severance pay or supplemental unemployment benefits to the owner-employees if they represented more than 4% of the total number of eligible participants. This would mean that a sponsoring employer would have to have 25 employees for every owner-employee who wished to participate in a severance or supplemental unemployment benefit. Also, the Department of Labor should be consulted in regard to these two benefits because of its current jurisdiction in this area. They have provided substantial guidelines for these benefits. Severance pay should be redefined as a retraining benefit, and not applicable to owner-employees if they represent more than one twenty-fifth of the eligible membership. This would leave approximately six permissible benefits for limited membership (professional corporation) programs: Major

Medical/Hospitalization, Disability Benefits, Death Benefits, Vacation Pay, Holiday Pay, and Sick Pay. Major Medical/Hospitalization would have to be equal for all participants, as dictated by Section 125 of the Code. Disability Benefits would have to be the same percentage of compensation for each participant, as prescribed by the 501(c)(9) Regulations. Death Benefits would have to be the same multiple of compensation for each participant, as prescribed by the 501(c)(9) Regulations and further governed by Sections 79 and 101 of the Code. Vacation Pay would have to be on a proportionate basis, and again, it could be provided that the owner-employee could not receive more than 25% of the total benefit provided. Holiday Pay and Sick Pay should be the same as Vacation Pay.

The above changes have been suggested to the Internal Revenue Service, as well as to Chief Counsel's Office by CCI for the last several years. However, we have installed each one of these changes in our limited membership programs. Also, we require a corporate trustee (a bank or a trust company).

Last, the use of an enrolled actuary to determine that the contribution is actuarially sound in regard to the type of benefits, the size of the benefits being provided, and the type of funding being used, should be a prerequisite for Exempt Organization filing. There is currently a Revenue Ruling in existence which does not require an actuarial report for a smaller plan; however, this could be remedied with a very simple addition to the 501(c)(9) Regulations.

2. Deductibility of contributions: (a) amount, (b) timing

(a) The size of the contribution should be actuarially determined to be sound. (Refer above for explanation.) This contribution, however, should not be based on the level funding concept associated with qualified retirement plans. VEBA reserve requirements are determined by future claims for benefits. There is a certain degree of uncertainty inherent in evaluating these needs. In contrast, retirement plan needs are for a stated amount of benefit over a stated period of time. (Refer to Technical Advice Memorandum LTR 8023016 and 8309004 for further details.)

(b) The contributions to welfare plans (VEBAs) are irrevocably made. The funds (unlike overfunded retirement plans) may never be returned to the corporation. The dissolution section attached, along with this irrevocable commitment of funds, should be more than enough reason that the contributions should be deductible in the year in which they are actually paid (most limited membership/professional corporation plans are cash basis taxpayers and these contributions must be made by the last day of the plan's fiscal year in order for these contributions to be deductible). Tying of the deductibility of the contribution to rules that currently govern non-qualified deferred compensation ignores the very different needs for reserves of two disparate concepts—qualified retirement plans and welfare plans.

3. Favorable tax treatment of contributions

Benefits that are provided by welfare plans funded by employer contributions, both of which are afforded favorable tax treatment, are required to meet stringent tests. Numerous sections of the Code and Regulations (along with the associated Tax Court and Revenue Ruling cases) provide for these tests. Each benefit must comply with the above parameters, along with the formulas provided by the 501(c)(9) Regulations, before this favorable tax treatment is afforded the contribution and benefit payments (e.g., medical benefits are subject to Sections 125(b), (e), (g), and (h), along with Section 501(c)(9) and ERISA).

Consideration of limiting the favorable tax treatment of the employer contributions based upon the tax treatment of the benefits when received by the employees illustrates the application of a "quick-fix" approach to revenue raising. This disregards the purpose of providing the incentive to employers to continue these benefit programs without the financial hardship that would otherwise occur without these dual incentives.

Level funding based on payroll in unacceptable to the financial integrity (actuarial soundness) of the reserves needed to assure payments for benefit claims now or in the future. All of the claims for benefits in the VEBA (welfare plans) are due to an unanticipated event. Therefore, unlike the predictability of a retirement plan, VEBA needs reserves which go far beyond percentage of payroll or any percentage of the annual cost of providing these benefits in the pact (refer to Technical Advice Memorandum LTR 8023016 and LTR 8309004)

4. Eligibility to participate

The problem in this area arises from the false assumption by the legal and accounting community that qualified retirement plan restrictions are suitable for VEBAs. Many of these programs have been utilizing the 3 years of full-time continuous service plus age 25 as the entry requirement for the VEBA. However, Exempt Organizations has been rejecting these programs on a regular basis. Also, the elimination of the limiting, of serverance pay and unemployment compensation will have the effect of allowing all full-time employees with 30 days to 90 days of service to be eligible to participate in the VEBA. Possibly, stronger language in the eligibility and participation sections of the 501(c)(9) Regulations, limiting the waiting period to no longer than six months to a year, would be appropriate.

5. Vacation and recreational facilities

Unless the owner-employee represented one twenty-fifth, or less, of the total eligible membership for benefits under the 501(c)(9) (VEBA), he could not participate in this benefit. Also, it would be required that employees would have equal right of usage, and easy access to the facility. Also, limiting the deductibility of the contribution for this benefit to depreciation, is an excellent idea. This could be done through a modification of Section 162 of the Code and the 501(c)(9) Regulations.

LTR 8309004, Date not given

Symbol: None given

NATIONAL OFFICE
TECHNICAL ADVICE MEMORANDUM

[Code Sec. 512]

Unrelated business taxable income; Taxable v. not taxable; Definitions; Section 501(c)(7) or (9); Unreasonable accumulation.--CCH.

ISSUE

Does M have reserve accumulations which are unreasonable in amount or duration for an organization described in section 501(c)(9) of the Code?

FACTS

M is a trust that serves as the fund through which disability and survivorship benefits are paid to members of an employee welfare benefit plan, which has been in effect for about ten years. The information available indicates that only a small percentage of participating employees are covered by a collective bargaining agreement. M's assets are comprised exclusively of contributions by N, plus investment income earned from such amounts. M is recognized as exempt under section 501(c)(9) of the Internal Revenue Code.

The information available indicates that N's contributions to M are determined on the basis of actuarial methods and assumptions selected in accordance with generally accepted actuarial principles and practices established by the American Academy of Actuaries.

LAW

Section 501(c)(9) of the Code provides for the exemption form federal income tax of voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries.

Section 511 of the Code provides for the imposition of tax on the unrelated business taxable income of certain organizations, including those exempt under section 501(c)(9).

Section 512(a)(3)(A) of the Code defines the unrelated business taxable income of a 501(c)(9) organization as the gross income (excluding any exempt function income), less allowable deductions, both computed with certain modifications.

Section 512(a)(3)(B) of the Code defines exempt function income as the gross income from dues, fees, charges or similar amounts paid by members of the organization as consideration for providing such members or their dependents services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid. Exempt function income is further defined as all income (other than an amount equal to the gross income derived from any unrelated traded or business regularly carried on by the organization), which is set aside by an organization described in section 501(c)(9) to provide for the payment of life, sick, accident or other benefits, including the reasonable costs of administration directly connected with these payments.

DISCUSSION

The legislative history of section 512(a)(3)(B) of the Code indicates that investment income is an integral part of the exempt insurance function of an organization exempt from federal income tax under section 501(c)(9). Section 512(a)(3)(B) serves to remove from the unrelated business income tax an organization's investment 'income where that income is committed to provide for the payment of life, sick, accident, or other benefits within section 501(c)(9). Refer to S. Rep. No. 91-552, 91st Cong., 1st Sess. 72 (1969), 1969-3 C.B. 470.

Generally, income that is to be set aside for the purposes specified in section 512(a)(3)(B) of the Code must be specifically earmarked as such or placed in a separate account or fund. However, in the case of a 501(c)(9) organization, which by the terms of its governing instrument must use its net investment income for life, sick, accident, or other benefits, the income and assets of the organization can be considered as committed to purposes within section 512(a)(3)(B) without any additional action by the organization's governing body. Additional actions, such as a trust amendment or resolution stating that investment income is committed to purposes under section 512(a)(3)(B) would merely make explicit the existing fact that the income and assets of the organization are already committed to purposes within sections 501(c)(9) and 512(a)(3)(B) as a requirement of the organization's exemption under section 501(c)(9). Accordingly, in the case of a voluntary employees' beneficiary association, which by the terms of its governing instrument uses its net investment income for life, sick, accident, or other benefits, net investment income need not be otherwise designated by the organization to be considered properly set aside.

Although set-aside income may be accumulated, any accumulation which is unreasonable in amount or duration is evidence that the income was not accumulated for the purpose set forth in section 512(a)(3)(B) of the Code.

In the case of 501(c)(9) organization, accumulations which are reasonably necessary for the purpose of providing life, sick, accident, or other benefits to members, are not unreasonable even though such accumulations may be quite large and the time between the date of receipt by the organization of such amounts and the date of payment of the benefits is quite long. On the other hand, if an accumulation has become unreasonable in amount or duration, through continual additions to it over a period of years, it would no longer be reasonably necessary to set aside additional amounts to be added to the accumulated reserve.

There is no specific statutory language or published precedent concerning the reasonableness of the amounts of funding of a 501(c)(9) organization. Whether or not an accumulation of funds is unreasonable in light of the exempt insurance function of a 501(c)(9) organization is a question requiring consideration of the detailed facts and circumstances of a particular case.

There are many valid purposes for which a 501(c)(9) may accumulate reserve funds. The existence of reserves allows such an organization to conduct its activities without interruption during financially adverse periods, such as, for example, strikes, lock-outs, and economic recessions. Normally, as is the case here, a voluntary employees' beneficiary association is almost totally dependent on employer contributions for its funds. Therefore, it would of necessity be forced to suspend or substantially reduce operations if these employer contributions were to be totally cut off or substantially reduced unless it retained a reasonably large reserve fund.

Many 501(c)(9) organizations are created and operated pursuant to a collective bargaining agreement between participating employers and labor unions representing the members of the employee's association. In these cases, the specific financial details of the employee's association operations, including the amount of the benefits to be paid to the members, and the amount of reserves the employees' association may accumulate, have been determined as a result of arm's-length negotiations between adversary parties. In this manner, the collective bargaining process acts as a control against the unreasonable accumulation of funds.

In this case, only a small percentage of participating employees are covered by a collective bargaining agreement. Thus, we have no assurance that the amount of accumulations under the plan were determined as a result of arm's-length negotiations between adversary parties. However, all the facts and circumstances indicate that the accumulations are reasonable. We are dealing with a relatively new plan. Under a disability plan of this type, liabilities under the plan will generally increase as the plan ages and a greater number of employees become eligible to receive disability benefits. It is prudent to attempt to fund such future liabilities in the early years of the plan's operation, rather than risk the possibility that the plan may be under-funded in future years when many employees may be depending on the plan's benefit payments for their livelihood. N's contributions to M have been determined on the basis of recommendations made in the annual reports of an independent actuarial firm. Those reports considered long-term trends in computing plan costs. The reports indicated that plan costs, expressed as a percentage of pay, will rise year by year as a result of an anticipated rapid increase in the component cost for post-retirement survivors benefits over the next ten years. Nothing in the information available would indicate that such actuarial reports are inaccurate, nor is there any evidence that any funds have or will be set-aside for any purpose other than the payment of disability and survivorship benefits.

CONCLUSION

For the reasons set forth above, we conclude that M has set aside its investment income for purposes set forth in section 512(a)(3)(B) of the Code. Accordingly, M's net investment income for the year in question constitutes exempt function income under section 512(a)(3)(B) and, therefore, is not subject to tax as unrelated business income under section 511 of the Code.

LTR 8023016, February 25, 1980

Symbol: EP:EO

NATIONAL OFFICE TECHNICAL
ADVICE MEMORANDUM

[Code Sec. 501]

Exemption from tax on corporations, certain trusts, etc.; Exempt v. not exempt; Voluntary employees beneficiary associations; Health and welfare fund reserve accumulation.--CCH.

ISSUE

1. Whether investment income received by an organization that is exempt from federal income tax under section 501(c)(9) of the Internal Revenue Code may be set aside as provided in section 512(a)(3)(B) when the organization has accumulated a reserve that is unreasonable in amount or duration.

2. Whether the organization's reserve accumulation for the years in question is unreasonable in amount or duration.

FACTS

M is an organization that is exempt from federal income tax under the provisions of section 501(c)(9) of the Code. It was created pursuant to a collective bargaining agreement between participating employers and labor unions representing the members of M. It is administered by a Board of Trustees consisting of representatives of the employers and the unions.

M's purpose is to provide group life insurance, group health and accident benefits, group hospitalization, medical and surgical benefits, or any other such benefits and insurance as may be determined by the trustees. The fund may be used only for health and welfare benefits for the employees and the families and dependents of the employees, and reasonable and necessary administrative expenses.

M is funded by contributions from the employers of M's members and by the

interest and dividends earned by investment of the contributions. Benefits to members are insured by a duly licensed insurance carrier.

The organization's receipts have exceeded its disbursements during all but one of the years that it has been in existence. Your figures indicate that during the years in question, the organization had surpluses of $4.2x, $2.2x, and $1.8x, respectively. Accumulated reserves at the end of each of those years stood at $10.3x, $12.6x, and $14.3x, respectively. As of the end of the period, the organization had on hand an amount more than sufficient to fund a full year of benefits and operating expenses.

APPLICABLE LAW

Section 501(c)(9) of the Code provides for the exemption from Federal income tax of voluntary employee's beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries.

Section 511 of the Code provides for a tax on the unrelated business taxable income of certain organizations including those exempt under section 501(c)(9).

Section 512(a)(3)(A) of the Code defines the unrelated business taxable income of a 501(c)(9) organization as the gross income (excluding any exempt function income), less deductions which are directly connected with the production of the gross income (excluding any exempt function income).

Section 512(a)(3)(B) of the Code defines exempt function income as the gross income from dues, fees, charges or similar amounts paid by members of the organization as consideration for providing such members or their dependents services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid. Exempt function income is further defined as all income (other than an amount equal to the gross income derived from any unrelated trade or business regularly carried on by the organization), which is set aside by an organization described in section 501(c)(9) to provide for the payment of life, sick, accident, or other benefits, including the reasonable costs of administration directly connected with these payments.

RATIONALE

The legislative history of section 512(a)(3)(B) of the Code indicates that investment income is an integral part of the exempt insurance function of an organization exempt from Federal income tax under section 501(c)(9). Section 512(a)(3)(B) serves to remove from the unrelated business income tax an organization's investment income where that income is committed to provide for the payment of life, sick, accident, or other benefits within section 501(c)(9). Refer to S. Rep. No. 91-552, 91st Cong., 1st Sess. 72 (1969), 1969-3 C.B. 470.

Generally, income that is to be set aside for the purposes specified in section 512(a)(3)(B) of the Code must be specifically earmarked as such or placed in a separate account or fund. However, in the case of a 501(c)(9) organization which by the terms of its governing instrument must use its net investment income for life, sick, accident, or other benefits, the income and assets of the organization can be considered as committed to purposes within section 512(a)(3)(B) without any additional action by the organization's governing body. Additional actions, such as a trust amendment or resolution stating that investment income is committed to purposes under section 512(a)(3)(B) would merely make explicit the existing fact that the income and assets of the organization are already committed to purposes within sections 501(c)(9) and 512(a)(3)(B) as a requirement of the organization's exemption under section 501(c)(9). Accordingly, in the case of a voluntary employee's beneficiary association which by the terms of its governing instrument uses its net investment income for life, sick, accident, or other benefits, net investment income need not be otherwise designated by the organization to be considered properly set aside.

Although set-aside income may be accumulated, any accumulation which is unreasonable in amount or duration is evidence that the income was not accumulated for the purpose set forth in section 512(a)(3)(B)(ii) of the Code.

In the case of 501(c)(9) organizations, accumulations which are reasonably necessary for the purpose of providing life, sick, accident, or other benefits to members, are not unreasonable even though such accumulations may be quite large and the time between the date of receipt by the organization of such amounts and the date of payment of the benefits is quite long. On the other hand, if an accumulation has become unreasonable in amount or duration, through continual additions to it over a period of years, it would no longer be reasonably necessary to set aside additional amounts to be added to the accumulated reserve.

There is no specific statutory language or published precedent concerning the reasonableness of the amounts of funding of a 501(c)(9) organization. Whether or not an accumulation of funds is unreasonable in light of the exempt insurance function of a 501(c)(9) organization is a question requiring consideration of the detailed facts and circumstances of a particular case.

There are many valid purposes for which a 501(c)(9) may accumulate reserve funds. The existence of reserves allows such an organization to conduct its activities without interruption during financially adverse periods, such as, for example, strikes, lock-outs, and economic recessions. Normally, as is the case here, a voluntary employee's beneficiary association is almost totally dependent on employer contributions for its funds. Therefore, it would of necessity be forced to suspend or substantially reduce its operations if those employer contributions were to be totally cut off or substantially reduced unless it retained a reasonably large reserve fund.

Many 501(c)(9) organizations are created and operated pursuant to a collective bargaining agreement between participating employers and labor unions representing the members of the employee's association. In these cases, the specific financial details of the employee's association's operations, including the amount of the employer contributions, the amount of the benefits to be paid to the members, and the amount of reserves the employee's association may accumulate, have been determined as a result of arm's-length negotiations between adversary parties. In this manner, the collective bargaining process acts as a control against the unreasonable accumulation of funds.

Accordingly, barring any unusual circumstances, where a 501(c)(9) organization has been created and is operated pursuant to a collective bargaining agreement between participating employers and labor unions representing the members of the employee's association, it will be presumed that the reserves accumulated by the 501(c)(9) organization are reasonable in amount and duration.

In this case, M was created and is operated pursuant to a collective bargaining agreement between participating employers and labor unions representing the members of M. The file does not reveal any unusual circumstances that would demonstrate that the agreement was reached by other than arm's-length negotiations between adversary parties. Thus, it will be presumed that the reserves M has accumulated are reasonable in amount and duration.

It follows, therefore, that M has set aside its investment income for the years in question for purposes set forth in section 512(a)(3)(B)(ii) of the Code. Accordingly, M's net investment income for these years constitutes exempt function income under section 512(a)(3)(B) of the Code and, therefore, is not subject to tax as unrelated business income under section 511 of the Code.

CONCLUSION

1. If a 501(c)(9) organization has accumulated a reserve account that is unreasonable in amount or duration, the organization cannot set aside its net investment income as provided in section 512(a)(3)(B) of the Code.

2. M's reserve account accumulation for the years in question is not unreasonable in amount or duration.

10.03 Termination or Complete Discontinuance of Contributions:

Although the Employer has established the Plan with a bona fide intention and expectation that it will be able to make contributions indefinitely, nevertheless the Employer is not and shall not be under any obligation or liability whatsoever to continue its contributions or to maintain this Plan for any given length of time. The Employer may, in its sole and exclusive discretion, discontinue such contributions or terminate this Plan in accordance with its provisions at any time.

In the event of the termination of the Plan, any assets remaining in the Trust, after satisfaction of, or provision for, all liabilities to beneficiaries then entitled to benefits under the Plan, may, at the election of the Committee acting in their sole and absolute discretion, be: (1) applied to provide either directly or through the purchase of insurance, life, sick, accident or other benefits within the meaning of Treasury Regulations Section 1.501(c)(9)-3 pursuant to criteria that do not provide for disproportionate benefits to officers, shareholders, or highly compensated employees of Employer, or (2) distributed outright, in cash or in kind, to the remaining participants. Such distribution of assets shall be made to each such Participant and in such ratio as described in the Trust document attached hereto in Section 7.03(b)(3).

7.03(b)(3) The providing of such benefits through such distribution is to be made in the following order: (1) the distribution of insurance contracts equal to the benefit each Participant would have received as of the last day of the preceding Plan Year. Each contract distributed is to be identical in its language, type, and provisions for each eligible Participant. (2) The next distribution (if any assets remain) is to be based upon the non-insurable type benefits (if any) that had been provided as of the last day of the preceding Plan Year. This distribution is to be based upon the gross amount attributable (or pro-rata amount if the assets are insufficient to provide the gross amount) under these benefits. (3) Finally, any and all remaining assets after the above have been satisfied are to be distributed in accordance with Section 501(c)(9)-4d.

(4) The Participants who shall be entitled to receive distributions, as provided in subparagraph (3) above, shall be the following:

(A) All Participants employed by Employer on the effective date of the termination of the Plan.

(B) All Participants whose employment with Employer terminated prior to the effective date of the termination of the Plan and who satisfy each of the following requirements:

(i) Termination of employment occurred within 5 years preceding the effective date of the Plan termination.

(ii) Following the termination of Participant's employment, a new employee was not hired to replace his position.

(iii) The position of employment of the Participant existed for at least 3 years prior to the Participant's termination of employment.

(5) The most recent eligible Participants, as of the last day of the Plan Year, not less than three Plan Years and not more than five Plan Years previously, are to receive these distributions. This determination is to be made by the Plan Committee, the Plan Administrator, and the Trustee. The accuracy of the Census Data is the strict fiduciary responsibility of the Plan Committee. This information is to be relied upon by the Plan Administrator and the Trustee. This Census Data is to be supplied on an annual basis to the Trustee, in written form, accepted and approved by the Trustee and verified in writing by the Plan Committee.

Mr. PICKLE. And now we will go to Mr. Peter Hutchings.

STATEMENT OF PETER HUTCHINGS, PARTNER, KWASHA LIPTON, AND CHAIRMAN, CAFETERIA PLANS TASK FORCE, ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS, INC., ACCOMPANIED BY ED DAVIES, CHAIRMAN AND EXECUTIVE DIRECTOR

Mr. HUTCHINGS. Thank you, sir.

My name is Peter Hutchings. I am a consulting actuary, and I appear before you representing the Association of Private Pension and Welfare Plans. Our prepared testimony includes a block dealing with flexible benefits or cafeteria plans, much of which has been covered by the earlier panel. I would simply add two points.

First of all, while one could argue that the requirement of preelection that is contained in 84-22 could have been anticipated, it is very difficult to argue that the requirement of a forfeiture of risk element could have been anticipated. This, it seems to us, suggests that the final resolution of this matter should be prospective, since it would not have been possible to anticipate this result otherwise.

My second point on cafeteria plans has to do with specifically dependent care. Experience has shown that cafeteria plans are one of the best ways to adopt a dependent care program for an employer and his employees. Those who feel that dependent care employee benefits are a bad idea consider this to be a weakness of cafeteria plans. Those of us, however, who feel that dependent care is an appropriate area for employee benefits consider it a virtue of flexible benefit plans that they do permit these very important needs to be met.

In the balance of my time I would like to pass a couple of comments about the February 17 draft in terms of proposals relating to tax shelters. Toward the end of that draft there is a section that identifies a bizarre practice which sounds to us like a credit card/checking account/pension plan.

I can assure you that our Association has no interest in credit card/checking account/pension plans. However, the proposed remedy to eliminating this peculiarity involves changing the taxation approach to employee contributions, and this would have the, I am sure unintended, effect of having a major impact on one of the most popular employee benefits in America, and I refer here to savings plans.

Savings plans have been around for decades. They impact on tens of millions of employees. They commonly have an employer contribution, they commonly have an employee contribution. Any number of Americans have relied upon these plans, both in terms of looking to their retirement supplement needs, but also, as the name suggests, in terms of other forms of savings.

It would be a very radical change and upset settled expectations to change the taxation of these just so we can deal with these other checking account/pension plans. I am sure we can get rid of checking account/credit card/pension plans without impacting on thrift savings plans.

A second point, the proposals of February 17 include a number of items that would bear directly on 401(k) cash or deferred arrangements. These arrangements have been around in their present form since 1978 and have been very popular. These plans are doing very well for their sponsors and the employees.

Experience tells us that a cash or deferred arrangement requires broad-based employee participation if it is to meet its objectives. The rank and file employee involvement is crucial for these plans to succeed. We are concerned that the proposed substantial tightening of hardship revisions will adversely affect on the ability of the rank and file to participate in these plans.

A second point that is also addressed on 401(k) plans: We are concerned with the proposed change of the one-third/ two-thirds test that is suggested, where an arbitrary dollar figure would be used rather than the one-third/two-thirds cut point that is presently established.

Arbitrary dollar figures tend to not work out too well when you consider regional variations in wages, and discrimination has always been judged on a relative basis within a corporation. We do not think that the dollar cut point substitute for the existing one-third/two-thirds mechanism is necessary.

Finally, we note with interest the objective of the committee to deal with abusive 501(c)(9) VEBA organizations, and we would observe that the 501(c)(9)'s have been used extensively by major employers to fund valid, worthwhile employee benefit plans. We are a little bit concerned at the technical operation in this highly complex area, the ins and out of some of these reserve requirements, and we are concerned that people be able, companies be able, to soundly found for postretirement life benefits and health benefits and disability income postretirement.

In summary, if I might, employee benefits, which is our concern here, are not easily changed by companies. Employees and employers need stability to operate these plans effectively, and we think this is very important, and we are eager to help address these issues in any way we can.

Thank you.

[The prepared statement follows:]

STATEMENT OF PETER HUTCHINGS, ON BEHALF OF ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS, INC.

Mr. Chairman and Members of the Committee, my name is Peter Hutchings. I am a consulting actuary with Kwasha Lipton practicing in the area of flexible benefits. I appear before you today representing the Association of Private Pension and Welfare Plans, Inc.

Our Association represents several hundred plan sponsors of all sizes. Our membership also includes a number of consulting firms, insurance companies, banks, accounting firms, and others associated with employee benefit plans. Our concerns cover the entire range of employee benefit questions. We appreciate the opportunity to appear before you today.

We are deeply interested in a great many of the issues being discussed here, and we have selected a few key areas for comment today.

CAFETERIA PLANS

In the last few weeks, cafeteria or flexible benefit plan designs have been criticized as "without substance". A great deal of outrage and indignation has surfaced, and we want to take this opportunity to address this area.

First point

Some of America's largest and finest corporations have adopted those programs to benefit their employees generally. These are not the type of companies to play audit lottery with their fringe benefit programs. This is not the sector of our economy where benefit abuses are found.

Second point

The specifics of these plans vary widely. Some involve pre-election and salary reduction. Some involve company funding in the form of "credits". And some involve recharacterization of the employee's otherwise agreed upon salary as tax-free reimbursement without preelection.

IR 84-22, released on February 10, attempts to retroactively disallow the last plan design without clearly indicating which if any of the other designs are valid. One can safely assume that the release of draft regulations more than five years after passage of Code § 125 would have precluded the adoption of 90% of plans now being challenged. We feel that retroactive penalties are not justified when we consider all the circumstances.

Third point

One principal reason for the adoption of flexible benefit plans by major employers has been to address the problem of outdated medical plan designs and the excessive fringe benefit costs these designs produce.

In the past, the tax code has been a powerful incentive for the growth of employer-pay-all first dollar coverage benefits. Certainly employees today are far better protected from the economic effects of illness as a result of employer-sponsored medical plans. However, many feel that this approach has been carried too far in some cases. In particular, the individual consumer of health care may have lost touch with the costs of care in general or the economic impact of his own health care decisions in particular.

Employers who feel that first dollar plans have outlived their usefulness see flexible benefits as an opportunity to reassess medical plan design in light of the realities of the 1980's. These reassessments not infrequently result in the injection of increased deductibles, coinsurance or employee contributions into the health benefit. These changes are designed to increase employee involvement in the cost of benefits, and to get away from the first dollar coverage mentality.

Where these kinds of benefit changes are made, cost savings usually result. Using flexible benefit principles, it is often possible for the employer to allocate these savings back to the employees for their use to buy additional benefits or for other purposes at the employee's option. Similarly, many plans permit employees to supplement the funds available for benefits with their own money through salary reduction.

The net effect of these changes can greatly heightened employee satisfaction and involvement as well as better employer cost control, especially in the health benefits segment. Flexible benefits have given American business a health care cost containment tool of proven value, by permitting employee—acceptable plan redesigns. It would be tragic to throw this tool away.

Fourth point

Employees like flexible benefits. The modern American workforce is considerably more varied today than it was only ten or fifteen years ago. Two-earner families and women heads of households are particularly likely to have unique benefit needs, and these are just the type of employees whose participation in the workforce is growing.

Flexible benefit programs enable employees to trade unneeded benefits in one area for cash, or for extra benefits in another area. A good number of the programs in existence today allow additional benefits to be bought through salary reduction or salary conversion. As a result, employers can make much broader programs available on a cost and tax-effective basis.

From an employee point of view, there are obvious advantages to flexible benefits. Some people need more life insurance; some can use less vacation; some already have basic health benefits from a spouse; some need child care to be gainfully employed. The opportunity to trade off unneeded benefits in one area for extra benefits in another area is very welcome to thse employees.

MISCELLANEOUS EMPLOYEE BENEFIT CHANGES

Now I would like to focus on other matters discussed in the pamphlet prepared by the Joint Committee on Taxation, dated February 17, 1984.

Many of the proposals listed under the miscellaneous category in items 7 and 8, other than such items as employee leasing or checkbook pension plans described below, are not the type of practices which belong in a tax-shelter hearing. The proposals would alter legitimate employee benefit practices and care should be exercised before these rules are modified in the fashion proposed.

For example, let me turn to the proposal on withdrawal of contributions to pension plans. Under the proposal the ordering rule for employee non-deduction contributions would be altered so that employee non-deduction contributions would be deemed to be the last amount withdrawn from a plan, as opposed to the current rule under which such contributions are deemed to be the first withdrawn. Moreover, the amount withdrawn which is taxable to the employee would be subject to a 10% penalty tax if such withdrawal occurred prior to the time the participant separates from service, attains age 59½, dies or becomes disabled.

Such a change in the ordering rule and the 10% penalty would reverse the current rules which have been in effect for decades and adversely impact tens of millions of participants in contributory plans, especially thrift savings plans. Typically, the thrift savings arrangement provides for a matching employer contribution of 50 to 100 percent of what the employee contributes and vesting in the employer contribution is generally quite rapid. These types of plans are well established supplemental plans to a basic pension plan and have been popular with both employers and their employees. Under these arrangements, because they are supplemental retirement savings plans, employees have been permitted to withdraw all or some portion of their own contributions which previously have been taxed as income. Because of this withdrawal feature, employees, especially rank-and-file employees, have been willing to set aside substantial amounts of their money in order to enjoy the employer's matching contribution.

If the proposal made in the pamphlet were adopted, the expectation of these rank-and-file employees would be dramatically altered and suddenly they would find their contributions unavailable to them. Moreover, the recordkeeping problems for plan sponsors associated with such a change would be horrendous.

Unlike the well established and traditional contributory plan, the arrangement described in the Joint Committee pamphlet which appears to be the basis for changing the ordering rule, seems to be a bizarre plan which sounds like a credit card and checking account pension plan. Obviously, our Association has no interest in supporting such arrangements, and we would be glad to provide assistance to your staff to devise a rule which would shut-down these arrangements but allow the traditional plan covering millions of participants to continue to function.

The pamphlet also describes certain changes to cash or deferred arrangements. The rules under Code § 401(k) governing cash or deferred arrangements, were adopted by Congress in the Revenue Act of 1978. Since the enactment of this section, many employers and their employees have found these arrangements to be an attractive means of providing for a tax-efficient opportunity to supplement their savings for retirement.

The cash or deferred arrangement will satisfy Code § 401(k) requirements only if substantial numbers of rank-and-file employees participate in the plan. The proposals suggested in the pamphlet would discourage wide spread participation by rank-and-file employees by limiting the ability of such employees to elect to receive part or all of their accrued benefit under the plan as a "hardship" distribution.

Under the traditional qualified retirement plan rules governing "hardship" distributions, employees may receive amounts for such items as education, housing and medical expenses. In the current economic environment with historically high interest rates, which appear to be continuing into the future, these are obvious items which if incurred would be a hardship for an employee. Many rank-and-file employees, at all ages, would find it impossible to set aside amounts under a cash or deferred arrangement unless the flexibility to withdraw for these traditional hardships were available. For these reasons, adoption of the inflexible standard described in the pamphlet would severely limit rank-and-file participation.

We see no reason for such a proposal. Congress adopted the cash or deferred arrangement in 1978 to encourage savings by all employees. Now that vast numbers of employees are saving under these arrangements, exactly as Congress envisioned, it makes no sense to eliminate the traditional rules governing hardship distributions, thereby foreclosing the ability of rank-and-file employees from saying and the employer from maintaining these popular programs.

Moreover, the pamphlet describes other changes in the rules governing cash or deferred arrangements, which will discourage employers from maintaining such plans. For example, the rules governing rand-in-file participation would be modified to limit the number of participants considered in the lower ⅔ of the compensation range by placing an artificial compensation limit on the employees considered in this lower ⅔ range. Such a proposal would needlessly complicate the rules under

Code § 401(k)). In addition, such compensation limit would arbitrarily restrict a company in determining contribution levels. Under the current rules all companies look to the upper and lower ⅓ and ⅔ of the compensation range for purposes of satisfying the Code § 401(k) standards. If, as proposed under the pamphlet, a company may only consider employees earnings below a certain level as participants in the lower ⅔ of the compensation range, companies in locations where the cost of living is high, e.g., New York, Washington, D.C., will be unable to reach the same contribution level for all employees as those locations where the cost-of-living is substantially lower. This, like the proposed cap on health care, can not be fairly administered and should be rejected.

VOLUNTARY EMPLOYEE BENEFIT ASSOCIATIONS

Finally, we applaud the Joint Committee staff goal of closing down abusive arrangements under § 501(c)(9) trusts or VEBA's—voluntary employee benefit associations. We are concerned, however, that the Joint Committee proposals will adversely impact employer and union sponsored § 501(c)(9) trusts to fund long-term disability benefits and post-retirement life and health benefits by not allowing sufficient reserves to guarantee benefits provided under these programs. The Joint Committee proposals in this highly technical area are in need of much more discussion and analysis in order to ascertain the impact they would have on legitimate and socially beneficial VEBA's.

We urge the Committee and Staff to allow for maximum input from the responsible employer community on all these issues. Employee benefits are not easily changed. Employers and employees need stability to operate these plans effectively. We are eager to help in any way we can.

Mr. **Pickle**. I want to get the rest of the testimony and we will proceed with it. But I have been handed here a copy of the Financial Planner from August of 1983, and the headline was how to provide low-cost vacation benefits through a VEBA.

And then, since you mentioned this subject, it points out that the Internal Revenue Code section 501(c)(9) exempts from taxation voluntary employee beneficiary associations, VEBA's, and primarily for the payment of life, sickness, and other dependent problems. But it says "for life, sickness, accident or other benefits."

Now, among the other benefits pointed out as benefits spelled out in the Code are vacation benefits, vacation facilities, and recreational facilities. Does a VEBA recommend that you stress that and are you selling those vacation plans?

Mr. **Hutchings**. The association that I represent this afternoon is the association of private pension and welfare plans. The kinds of VEBA's that I was addressing in my testimony were——

Mr. **Pickle**. But here the kind of programs they are selling are vacation plans.

Mr. **Hutchings**. I believe I can say with confidence that our association has no involvement or interest in or is, quite frankly, concerned with vacation homes. We are worried about accidental damage that might be done to employer sponsored long-term disability and retirement, life and health plans as the committee addresses these peculiar things.

Mr. **Pickle**. All right. Thank you very much.

Now Mr. Swanke represents the Independent Business Association of Minnesota. Mr. Swanke.

STATEMENT OF R. B. SWANKE, SECRETARY, INDEPENDENT BUSINESS ASSOCIATION OF MINNESOTA, AND VICE PRESIDENT, SOCIETY OF PROFESSIONAL BENEFIT ADMINISTRATORS

Mr. **Swanke**. Yes. Mr. Chairman and Mr. Committee: I am Bob Swanke from Minnesota. I am the secretary and a board member of the Independent Business Association, which is made up of about 2,500 businesses in Minnesota.

I am also vice president of the Society of Professional Benefit Administrators. Our business is to administer self-insured 501(c)(9) trusts, employee benefit plans which include health insurance, disability, income insurance, dental insurance, and vision insurance. That is the total spectrum.

Mr. PICKLE. What was the last one?

Mr. SWANKE. Vision.

Mr. PICKLE. Are you selling vacation plans, too?

Mr. SWANKE. No, sir. I have covered the entire spectrum of our business.

I have been in the business of administration for about 25 years, some 33 years in employee benefits. I am not here to defend 125, 401(k), or any other frisky type program. We administer for the small business community, 35 employees to 1,000. And I can understand the Internal Revenue, Treasury, and this committee looking into some of the other areas that 501(c)(9) has stretched out to cover.

I am here today to make one point: That in the programs that we are administering—we administer for political subdivisions, for Taft-Hartley trusts, jointly administered union plans, trade associations, and private corporations. It appears in the attitude that is being taken toward the 501(c)(9) that it could well broad brush the entire concept down the drain.

And I am here again, as I mentioned earlier, to point out that those benefit programs that we are administering do not in any way affect the tax income of the Government levels. When we set up a 501(c)(9) trust or a VEBA, as it has been called in the last couple of years, for an employee benefit plan, it is in replacement of an insured plan. We set it up with a trust in a bank, an employee welfare benefit plan, right from the language of 501(c)(9), and under the jurisdiction of 501(14)(b), which allows a broad latitude of benefits structure.

In most cases these plans are prefunded so that they are solvent in all respects. In every case that we have ever put together, we use an insurance company for stop loss, specific stop loss on the individual claim and an aggregate stop loss on the group's liability as a whole.

Fred Hunt from the Society of Professional Benefit Administrators made a reference to reserves, and in reading the work from staff I understand they are looking at 50 percent. However, 50 percent of the last 3 years could have a very limiting effect on proper reserves, in that in prior years loss ratios could have been substantially lower, taking the last 3 years and historically going back and not giving credibility for the economic trend of medical costs.

I agree with Fred Hunt from the society that 50 percent of the next year's projected liability is adequate reserves. This would mean that that employer or that Taft-Hartley trust or that association could deposit during the course of the contract year the amount of money to cover claims liability, to cover the administrative fee, to cover the insurance cost for stop loss, and to cover the reserve for incurred but not reported claims in the event the plan terminated.

Now, in almost every circumstance that contribution that this employer or this Taft-Hartley trust is making will be less than if you were on a fully insured program. The cost containment and the cost effectiveness of using a self-funded 501(c)(9) has proved to be less expensive than insurance.

The end result, if in a broad-brush approach to 501(c)(9) this concept would go down the drain, the end result would be a decrease in revenue to Internal Revenue by reason of this liability being shifted to the fully insured program.

We live by the rules of discrimination that have been produced by EEOC and we live by the rules of stop-loss insurance companies. Never in the years that I have been in the administration of this type of a contract have we had a situation where the highly compensated got favorable treatment. In putting the insurance together, both the stop-loss carrier and as the administrator, we recognize this.

I believe that this concept can live successfully without infringing on the areas that Treasury has referred to in the release about this.

I thank you for listening to me today, and if there is any questions I stand ready to answer them.

[The prepared statement follows:]

STATEMENT OF R. B. SWANKE, SECRETARY, INDEPENDENT BUSINESS ASSOCIATION OF MINNESOTA

Mr. Chairman, my name is Robert B. Swanke. I am Chairman of the Board of Swanke, Inc. We are a third party administration firm located in Minneapolis, Minnesota. I am also Secretary and a Member of the Board of the Independent Business Association of Minnesota (IBAM), for whom I am speaking today to express concern over the VEBA IRC section 501(c)(9) provisions included in the Joint Committee on Taxation report and proposals from the Department of Treasury.

I should also mention that I am Vice President of the Society of Professional Benefit Administrators. I congratulate you for including SPBA in this hearing. It is estimated that one-third of all U.S. workers are covered by the plans administered by such firms.

The Independent Business Association of Minnesota is an organization of two-thousand-five-hundred (2,500) small businesses in our state. We are representative of scores of similar groups in every state of the union. The Board and members of IBAM asked me to testify, using the insight and experience of my firm, which serves not only IBAM members, but also employers across the country with between 35 and 1,000 workers.

IBAM, and my client employers in other states are very concerned over the apparent misconception that 501(c)(9) VEBA plans are for the purpose of tax evasion. They are not. While our preferred client plans are "small", (35-1,000 workers each), they do represent virtually every type of sponsor . . . including political subdivisions, such as local, county, and state employee groups . . . Taft Hartley union/management jointly administered plans . . . plans sponsored by trade associations for member employers . . . and large and small single employer corporate employers.

VEBAs have been in existence since 1928, and I have been using them since 1970. The small businesses whom I represent today (who participate in plans by all kinds of sponsors) subcontract their services or products to larger firms. Thus, cost-effectiveness is a very necessary competitive edge. I might add that in our part of the country, especially, that competitive edge translates into the difference between jobs . . . and loss of jobs to foreign employers who can be cost-effective. It is neither frivolous nor venturesome, and the primary beneficiaries of VEBA plans are blue collar workers who need the basic benefits provided. It is not a tool for a few highly-paid employees.

In reading the report of the Joint Committee on Taxation and the proposals of the Department of Treasury, I was alarmed to see that they have assumed that reserves can be equated with abuses. That is simply not accurate. VEBAs have a very responsible record of reserving policy. While there is an aim for maximum flexibility in reserving options for an employer plan . . . in order to maximize cash flow for the firm and thus stay in business, most small business plans have "stop loss" insurance. Stop-Loss is simply a very high deductible policy which stops the loss if there are unexpected excessive claims. The stop loss insurance company endorses all of the legal requirements relating to anti-discrimination . . . including safeguards against abuse by highly-compensated individuals. You can be very sure that these insurance companies very carefully examine the risks and reserves within those plans. The other advantage of VEBAs using stop-loss insurance is that there is a known maximum risk for the employer and the plan. While stop-loss and the companies which provide that line of insurance are useful in many VEBAs, I do not mean to imply that stop-loss outside coverage is necessary in all types of VEBAs.

I was quite concerned to see the suggestion in the Joint Committee on Taxation report proposing a safe harbor of reserves of only 50% of the average of the last 3 year's claims. Obviously this is an error, since this does not include a substantial liability for Incurred But Not Reported (IBNR) claims, which eventually come to every plan when the premiums stop. It also does not take into account any of the overhead or administrative costs of a plan. It also does not take into effect inflation in medical costs and the constant rise of costs for new medical technology and techniques. If the current proposal were left as it is, the result would be a flow of disgruntled patients with unpaid bills demanding reform from you and relying on publicly-paid benefits such as Medicare/Medicaid and Social Security. I am also concerned, because in my role with the Society of Professional Benefit Administrators, I know that this was an incorrect reporting of information from SPBA. Even more alarming, this report and proposal seem to ignore and diverge significantly from the mandates of the Department of Labor and the other government agencies with Congressionally-mandated authority over employee benefits. Is the intent of this proposal to repeal ERISA and the many other employee benefits laws?

Thus, Mr. Chairman, I come to you today as a professional benefit administrator in the name of small business to ask that you not cripple VEBAs, which provide the cost-effectiveness our businesses so desperately need . . . often making the difference between U.S. and foreign jobs. We also ask, in the name of the average workers who are the primary beneficiaries, that VEBAs not be unnecessarily crippled. If the Department of Treasury feels that there are abuses, then a far more accurate gauge should be used than inaccurately equating reserving policy with abuses.

Thank you, Mr. Chairman, for the opportunity to appear. The Independent Business Association of Minnesota felt that one of the primary values of my appearing today would be to answer any questions, from the perspective of an employee benefit plan administrator with hands-on experience with both small business and plans across the country. Therfore, I make myself available to you.

Mr. PICKLE. Thank you, Mr. Swanke.

Now we will hear from the Wyatt Co. and the White Motor Co.

STATEMENT OF B. RUSSELL COUPLAND II, COUNSEL, THE WYATT CO. AND WHITE MOTOR CORP., ACCOMPANIED BY HARRY A. DON, CONSULTANT, THE WYATT CO.; AND WALLACE B. ASKINS, FORMER CHAIRMAN OF THE BOARD, WHITE MOTOR CORP.

Mr. COUPLAND. Thank you.

My name is Russell Coupland, and to my right is Mr. Harry Don of the Wyatt Co., and to my far right is Mr. Wallace Askins, former chairman of the board of White Motor Corp.

My comments relate to VEBA's which have been historically approved by the IRS, in that the nature of the benefit must necessarily involve asset accumulation in a trust to a very substantial degree. These VEBA's provide retiree health and medical benefits and long-term disability benefits.

The VEBA proposals must be tempered to assure that these may continue to operate. These VEBA's serve the substantial social purpose of enhancing the benefit security of retirees and their beneficiaries.

We are talking here about people who are retirees on fixed income, who have given 30, 40, or 50 years to their employer. These people are old, they are most susceptible to illness, and they cannot get health insurance. None of us like getting old, but the alternative is far worse.

As an example of why we should permit asset accumulation, consider the case of White Motor Corp.'s reorganization. One of the largest general unsecured debts was a $90 to $110 million debt relating to retiree medical and health insurance benefits, which was paid off at less than 50 cents on the dollar.

Because these benefits were not prefunded, the 4,000 rank and file White Motor retirees lost in excess of $45 million. The only vehicle for prefunding would have been a VEBA. The proposed definition of deferred compensation and the proposal to restrict reserves in VEBA's would prohibit the use of a VEBA to pay retiree health and medical benefits.

The cost of existing retiree medical and health benefits which is unfunded is extremely sizable for many companies. Studies performed by the Wyatt Co. and other actuarial firms have shown that the present value of that unfunded liability is often several times the employer's annual profits before taxes, and in some cases exceeds their net worth.

VEBA's are the sole means to accumulate funds to provide these benefits. Employers should be encouraged to systematically lay aside funds to meet the commitment to pay nondiscriminatory retiree health benefits through prefunding in a VEBA. Amounts laid aside in a VEBA are set aside irrevocably and cannot revert to the employer or be reached in a bankruptcy proceeding.

There is a question under bankruptcy law whether retiree health benefits would be a valid claim recognizable under the bankruptcy code. Thus, the use of a VEBA for retiree health benefits enhances the security of retirees in their benefits.

An appropriate model for permissible actuarial prefunding of health benefits through a VEBA is set forth in section 404 of the Code, the provision dealing with deduction of pension contributions. We would turn to section 404(a) as a model, an example of a prefunding method which should be permissible.

One method of funding under this model is an entry age normal valuation of the promised medical benefits, using reasonable actuarial assumptions with respect to interest, turnover, retirement age, and actual claims experience. A side benefit of this type of funding is that it will probably match income and expense for these benefits, a goal set by the administration at these hearings.

The committee may question why a qualified retirement plan would not be suitable for funding such retiree health insurance benefits, since section 401(h) of the Code permits the funding of such benefits. Before Section 401(h) may be used, it is essential that the health and medical benefits be subordinate to the retirement benefits provided by the plan. In today's environment of escalating health and medical costs and pressures to decrease medicare coverage, employers cannot be certain that the medical benefits will be subordinate.

Turning to long-term disability benefits, the proposal suggests that a reserve equal to 50 percent of 3 years' average benefit payments should be the maximum reserve under a VEBA. In order to properly match income and expense, the contribution level under a

VEBA should match contributions with the value of incurred claims. Such a contribution level will build up a financial reserve of approximately seven to ten years of claim payments.

This reserve is necessary so that the benefits of disabled members will not depend on future contributions. This is especially important in a VEBA that is funded solely by employee contributions.

Finally, the proposal suggests that a benefit paid over more than the current and the next year is deferred compensation, which cannot be provided under a VEBA. Long-term disability benefits must by their nature be paid over a period of years and have historically been provided under a VEBA. The only way to provide such benefits other than through insurance is a VEBA. Use of a VEBA to provide long-term disability benefits actually cuts the annual cost and thus the tax deduction of the employer sponsoring the VEBA.

[The prepared statement follows:]

STATEMENT OF HARRY DON, THE WYATT CO., B. RUSSELL COUPLAND II, SQUIRE, SANDERS, AND DEMPSEY, AND WALLACE B. ASKINS, FORMER CHAIRMAN OF THE BOARD AND CHIEF FINANCIAL OFFICER, WHITE MOTOR CORP., PRESENTED BY B. RUSSELL COUPLAND II, COUNSEL

TESTIMONY

Our comments relate to types of VEBAs which historically have been approved by the IRS and due to the nature of the benefit must, of necessity, involve asset accumulation in a trust to a very substantial degree. These VEBAs provide health and medical benefits and long-term disability benefits. The administration's VEBA proposals must be tempered to assure that these may continue to operate. These VEBAs serve the considerable social purpose of enhancing the benefit security of employees, retirees and their beneficiaries.

White Motor Corp.—example of need for prefunding retiree loss—$45 million

As an example of why we should permit asset accumulation, consider the case of White Motor Corporation's reorganization. One of the largest general unsecured debts was a $90 to $110 million debt relating to retiree medical and health insurance benefits which was paid off at less than 50 cents on the dollar. Because these benefits were not prefunded, the White Motor retirees lost in excess of $45 million. The only vehicle for prefunding would have been a VEBA. The administration's proposed definition of "deferred compensation" and its proposal to restrict reserves in VEBAs would prohibit the use of a VEBA to pay retiree health and medical benefits.

Retiree medical and health benefits

The cost of existing retiree medical and health benefits which is unfunded is extremely sizeable for many other companies. Studies performed by The Wyatt Company and other actuarial firms have shown that the present value of that unfunded liabiliity is often several times the employer's annual profits before taxes and in some cases exceeds their net worth. VEBAs are the sole means to accumulate funds to provide for these benefits.

Employers should be encouraged to systematically lay aside funds to meet the commitment to pay retiree health benefits through pre-funding in a VEBA. Amounts laid aside in a VEBA are set aside irrevocably and cannot revert to the employer or be reached in a bankruptcy proceeding. Thus, the use of a VEBA for retiree health benefits enhances the security of retirees in their benefits.

An appropriate model for permissible, actuarial pre-funding of health benefits through a VEBA is set forth in Section 404 of the Code, the provision governing deduction of pension contributions. An example of a pre-funding method which should be permissible under this model is an entry age normal valuation of the promised medical benefits, using reasonable actuarial assumptions with respect to interest, turnover, retirement age, and actual claims experience. A side benefit of this type of funding is that it will properly match income and expense for these benefits—a goal set by the administration at these hearings.

The Committee may question why a qualified retirement plan would not be suitable for funding such retiree health insurance benefits since Section 401(h) of the Code permits the funding of such benefits. Before Section 401(h) may be used, it is essential that the health and medical benefits be "subordinate to the retirement benefits provided by the plan." In today's environment of escalating health and medical costs and pressures to decrease Medicare coverage, employers cannot be certain that the medical benefits will be "subordinate."

Long term disability benefits

Turning to long-term disability benefits—the administration has suggested that a reserve equal to 50% of three years' average benefit payments should be the maximum reserve under a VEBA. In order to properly match income and expense, the contribution level under a VEBA should match contributions with the value of incurred claims. Such a contribution level will build up a natural reserve of approximately 7 to 10 years of claim payments. This reserve is necessary so that the benefits of disabled members will not depend on future contributions. This is especially important if the VEBA is funded solely by employee contributions.

Finally, the administration has suggested that a benefit paid over more than the current and the next year is "deferred compensation" which cannot be provided under a VEBA. Long-term disability benefits must by their design be paid over a period of years and have historically been provided under a VEBA. The only way to provide such benefits other than through insurance is under a VEBA, which actually cuts the annual cost and tax deduction of the employer sponsoring the VEBA.

INTRODUCTION

Testimony

Our comments relate to types of VEBAs which historically have been approved by the IRS and due to the nature of the benefit must, of necessity, involve asset accumulation in a trust to a very substantial degree. These VEBAs provide retiree health and medical benefits and long-term disability benefits. The administration's VEBA proposals must be tempered to assure that these may continue to operate. These VEBAs serve the considerable social purpose of enhancing the benefit security of employees, retirees and their beneficiaries.

Background

As used in the oral testimony, the term VEBA refers to a Section 501(c)(9) trust—a voluntary employee's beneficiary association. Such a trust is often established by employers to furnish long-term disability benefits and is recently being used to furnish health and medical benefits to retirees.

The administration, in its proposal as summarized in the Joint Committee on Taxation Staff Pamphlet on Tax Shelters and Other Tax-Motivated Transactions, has proposed rules severely limiting the amount and timing of employer deductions for contributions paid under a "funded welfare benefit plan," which is generally another name for a VEBA. The contribution to such funded welfare benefit plans would be limited to the sum of contributions includable in the income of employees and the amount necessary to increase a reserve under the plans to the "permitted level." The permitted level could not, according to the administration's proposal, "exceed 50 percent of the average annual benefits paid under the plan during the preceding 3 years." As demonstrated in the testimony which follows, the amount of such a reserve would be wholly inadequate with respect to two classes of plans which are customarily "funded" through a VEBA: long-term disability plans and retiree health and medical benefit plans.

WHITE MOTOR CORP.—AN EXAMPLE OF NEED FOR PREFUNDING RETIREE LOSS—$45 MILLION

Testimony

As an example of why we should permit asset accumulation, consider the case of White Motor Corporation's reorganization. One of the largest general unsecured debts was a $90 to $110 million debt relating to retiree medical and health insurance benefits which was paid off at less than 50 cents on the dollar. Because these benefits were not prefunded, the White Motor retirees lost in excess of $45 million. The only vehicle for prefunding would have been a VEBA. The administration's proposed definition of "deferred compensation" and its proposal to restrict reserves in VEBAs would prohibit the use of a VEBA to pay retiree health and medical benefits.

Background

In September of 1980, White Motor Corporation and its subsidiaries filed a petition under Chapter 11 of the United States Bankruptcy Code. Prior to filing that petition, White Motor had promised its salaried employees and certain of its hourly employees represented by the United Automobile, Aerospace and Agricultural Workers ("UAW") lifetime health benefits and certain death benefits.

Early in the White Motor reorganization proceedings, White and its creditors recognized that the promise of lifetime health benefits was an enforceable obligation. White had not segregated any funds for these benefits. It was recognzed that the promise of health benefits gave rise to a pre-petition general unsecured obligation. Such a general obligation shares with all other general unsecured obligations in the liquidation of the estate.

White Motor felt that it was important to establish a fund of assets from which these lifetime health insurance benefits could be paid and which would operate so that some funds would be available to even the last surviving beneficiary of that fund. To accomplish this objective, White's management sought to estimate the value of its commitment regarding health insurance to those persons who had retired from White (or were eligible to so retire) and their dependents.

White had contact with many members of the beneficiary class. For example, there was one hourly employee who had worked for 30 years for White Motor Corporation who had retired on an early retirement prior to the filing of the petition and whose wife was dying of cancer. We had lost a substantial portion of his early retirement supplement under the retirement plan which the Pension Benefit Guaranty Corporation claimed was not guaranteed and stood to lose more—a substantial portion of his wife's health benefits—unless a vehicle was found to maximize the dollars he and his wife would receive for health and medical benefits.

Insurance companies refused to insure the lifetime health and medical benefits. They estimated the single premium for doing so would be from $90 to $110 million. White's creditors knew they were building in a substantial, very conservative hedge against inflation of health benefit costs. After all, how often in today's environment does an insurance company offer lifetime health insurance on a guaranteed rate basis?

White's management learned that there was a special exempt organization—a trust—called a voluntary employees' beneficiary association which just might increase the dollars payable to the participants. As you probably know, creditors in a Chapter 11 proceeding preserve the debtor's estate to the maximum reasonable extent, even when it is employees of the debtor who are the creditors. In White's case, the employees were the second largest class of unsecured creditors, and the claim relating to retiree health, medical and death benefits was overwhelmingly their largest claim.

The structuring of the VEBA itself required extreme care. Only a fraction of each dollar of a general unsecured claim would be paid after confirmation of the Plan of Reorganization. This meant that the dollars that could be laid aside in the VEBA would only be a fraction of the present value of the health benefits which otherwise would have been payable. White engaged actuaries to determine how much the benefit would be, how long the benefits would be paid, and when the benefits would terminate. Each of these issues were wrestled with and it was decided that a schedule of benefits would be provided for 5 years and then, with an actuary's assistance, revised to meet the objective for the fund—that the last dollar of the VEBA was to be paid out (figuratively speaking) when the last retiree or dependent died. A committee revising the schedule of benefits periodically was the only feasible means to make it work. The committee had to be composed of retirees—no one else would serve.

The day-to-day administration of the claims against the VEBA was another story. An administrative services only contract was entered into with an insurance company for this purpose.

White's management was satisfied with the VEBA. It is today prefunded, providing hopefully lifetime retiree health benefits to White's retirees.

There is, however, one very important matter. White's former management wishes the Committee to realize that White would have sought to prefund the health benefits through a VEBA had it had any idea of the dollar magnitude of its commitment.

RETIREE MEDICAL AND HEALTH BENEFITS

Testimony

The cost of existing retiree medical and health benefits which is unfunded is extremely sizable for many other companies. Studies performed by The Wyatt Company and other actuarial firms have shown that the present value of that unfunded liability is often several times the employer's annual profits before taxes and in some cases exceeds their net worth. VEBAs are the sole means to accumulate funds to provide for these benefits.

Employers should be encouraged to systematically lay aside funds to meet the commitment to pay retiree health benefits through pre-funding in a VEBA. Amounts laid aside in a VEBA are set aside irrevocably and cannot revert to the employer or be reached in a bankruptcy proceeding. Thus, the use of a VEBA for retiree health benefits enhances the security of retirees in their benefits.

An appropriate model for permissible, actuarial pre-funding of benefits through a VEBA is set forth in Section 404 of the Code, the provision governing deduction of pension contributions. An example of a pre-funding method which should be permissible under this model is an entry age normal valuation of the promised medical benefits, using reasonable actuarial assumptions with respect to interest, turnover, retirement age, and actual claims experience. A side benefit of this type of funding is that it will properly match income and expense for these benefits—a goal set by the administration at these hearings. Furthermore, virtually all future cash flows are discounted for both interest and the probability of payment. When taken together with the irrevocable commitment of funds to a VEBA, we believe these contributions to the trust legitimately qualify for a current Federal income tax deduction.

The Committee may question why a qualified retirement plan would not be suitable for funding such retiree health insurance benefits since Section 401(h) of the Code permits the funding of such benefits. Before Section 401(h) may be used, it is essential that the health and medical benefits be "subordinate to the retirement provided by the plan." Section 401(h)(1). In today's environment of escalating health and medical costs and pressures to decrease Medicare coverage, employers cannot be certain that the medical benefits will be "subordinate."

Background

The social issue

Employers have over the last thirty or more years promised their employees that, if they work for them until retirement, they will receive lifetime health benefits. Such commitments cut down on the demand for increases in Medicare, cut down on the drain on those with fixed income and decrease the demand for Medicaid. Prior to the recent escalation in health care costs and the recent (almost simultaneous) shift to an older society, employers were largely unaware of the cost of such promises. Today, plant and divisional shut-downs have triggered greater awareness of the potential dollar magnitude of the promise. In some cases, the retiree health care promise is greater in dollars and cents than the pension plan promise itself.

Employers are starting to recognize the dollar magnitude of their commitment. They are exploring what vehicles exist to assure that their commitment is not an empty promise leaving employees as general creditors of a bankrupt entity. Employers wish to step up to their commitment on a basis that follows customary accounting principles of matching the cost of the benefit provided to the employee with the income generated by the employee's services. Employers' failure to do so now could produce a more serious problem with respect to retiree health benefits than that which existed with respect to pensions and produced the need to enact ERISA's minimum funding standards and the need to create the Pension Benefit Guarantee Corporation. Congress' actions with regard to VEBAs must be consistent with the social interest in encouraging employers systematically to lay aside funds to meet these commitments.

This concept of matching income with expense is inherent in the pension proposal of the Financial Accounting Standards Board ("FASB"), and the FASB has suggested that, after the pension proposal is finalized, the next area for appropriate accounting recognition is retiree health benefits. The FASB already requires recognition of the cost of such benefits at the time of the closedown of a plant or a line of business, under Accounting Principles Board Opinion No. 32, which is premised on the matching of income and expense recognition.

The FASB will probably require accrual accounting of these costs, but such accounting will serve only to reflect the proper financial position of the employer. Such accounting will be deficient in providing any benefit security. A book reserve would be all that would be created, and that book reserve could be wiped out in the case of a bankruptcy of the employer.

Cash costs for such retiree benefits and accrual costs can differ by almost a factor of 10. The Wyatt Company has worked on several cases where the cash cost was an insignificant amount, one tenth percent (0.1%) of the employer's gross income, while accrual costs—the more accurate picture of liability incurred as income is generated—was a very significant amount of one percent (1%) of gross income.

Cash costs for most companies will rise dramatically with respect to retiree medical costs because medical costs themselves will escalate and retired populations are growing. Most companies do not have matured retired populations. Cash costs go up more when the company's employment shrinks, and they are spread over a smaller base. On the other hand, accrual costs are much more responsive to employment levels and tend to go down when employment levels go down. If retiree medical benefits are fully funded at that time, the company's costs will be dependent only on the active workforce. The retirees' benefits will have been fully accrued and funded during their active lives. In this instance, when employment goes down, the costs themselves go down. It is a matter of growing concern that failure to fund these costs could in future years lead to many business failures.

Retiree health and medical benefit plans continue medical and hospitalization benefits for employees who have retired from employment with an employer after years of service with the employer. The employee during his employment with the employer can look forward to retirement with the belief that he will receive health insurance benefits in the future. Without funding that benefit during his employment, that belief could well be shattered.

The administration's proposal does contain provision for "a higher percentage [reserve]" to be permitted "under Treasury regulations in appropriate cases." If the administration's proposal is adopted, employers will need immediate guidance with respect to the ability to use VEBAs for long-term disability plans and retiree health and medical benefit plans and cannot be placed in the position of awaiting regulations which might not be forthcoming for years. For reasons discussed hereafter, employers must be encouraged to use VEBAs for provision of these benefits.

The only vehicle available to permit an employer to meet the retiree medical commitment systematically is a VEBA. The administration's proposal to defer the employer's tax deduction for amounts laid aside in the VEBA, to accelerate employee taxation on amounts in the VEBA, and to define such post-retirement medical benefits as deferred compensation (not permitted under a VEBA) disregards this social issue in the name of tax abuse.

Effect on a business enterprise of no funding; partial funding; full funding

A company which has not funded retiree medical beneifts may have little handle on what the magnitude of its commitment is as long as: (1) it has a younger workforce, and (2) it has an expanding workforce. Both of these factors serve to mask the true cost of the benefits. If, for example, retiree medical benefits for an employer which has 1,000 employees averages one percent (1%) of payroll, then what would happen if his employment dropped to 200 employees due to adverse business conditions? If the benefits were not funded, the benefits could easily rise to 4–5% of payroll. This happened to employers in many states in the mid-West. Furthermore, a decline in employment increases the number of persons retiring earlier, exacerbating the economics of the problem.

With a partially-funded retiree health insurance commitment, the burden is softened. With a fully funded commitment, some actuaries believe the percentage of payroll tends to remain constant.

Case studies

In the last week we have attempted to gather case studies for your consideration. We are prepared to go into these at the Committee's request.

A few case studies should be of usefulness to your Commitee. One company had a division with 45 employees and 150 retirees. The drain for retiree health insurance was such that the division was operating solely to attempt to support retiree health care costs.

Two companies learned, after exploring this problem, that the present value of the retiree health insurance commitment—without considering escalating health care costs—was 3 to 5 times their total annual income before taxes. Furthermore, in another case, the company learned that the present value of retiree health and medical benefits exceeded the company's net worth. We believe these case studies are representative of what exists nationwide.

Uselessness of retirement plans to provide retiree medical benefits

The Committee may question why a qualified retirement plan would not be suitable for funding such retiree health insurance benefits since Section 401(h) of the Code permits the funding of such benefits. Before Section 401(h) may be used, it is essential that the health and medical benefits be "subordinate to the retirement benefits provided by the plan." Section 401(h)(1). In today's environment of escalating health and medical costs and pressures to decrease Medicare coverage, employers cannot be certain that the medical benefits will be "subordinate." To be "subordinate," at all times the "aggregate contributions (made after the date on which the plan first includes such medical benefits) to provide such medical benefits . . . [must] not exceed 25 percent of the aggregate contributions (made after that date) other than contributions to fund past service benefits." Treas. Reg. § 1.401-14(c)(1). Thus, the regulations severely curtail the ability to accumulate funds for each health and medical benefits and relate such permissible accumulation to the contributions necessary to provide benefits to active employees. An employer with a substantial number of retirees could easily find that the cost of the medical and health benefits for current and retired employees far exceeds the normal costs of benefits under its pension or retirement plan.

Nonetheless, a provision of IRS regulations permitting acceleration of deductibility of contributions to a retirement plan under certain circumstances may be instructive to the Committee in that recognizes the appropriateness of matching deductibility of contributions to income. Section 404(a)(1)(B) of the Code prior to ERISA's enactment expressly provided a deduction on a level cost actuarial method. Under regulations describing permissible deductions under such a method, the Treasury Department stated that it would be permissible to deduct the costs of providing benefits under the plan for each individual covered thereby "as a level amount over the period remaining until the normal commencement of his retirement benefits, in accordance with other generally accepted actuarial methods which are reasonable and appropriate in view of the provisions of the plan, the funding medium and other applicable considerations." Treas. Reg. §1.404.(a)-5(d). Retiree health and medical benefits commence immediately upon termination of employment of the retirees, and, consequently, this principle suggests that such benefits could (if they were retirement benefits provided under a retirement plan) be funded over the anticipated active working life of the employees, as we have suggested above.

Revision of "deferred compensation" definition

The administration's proposal to revise the definition of "deferred compensation" raises substantial doubt in the minds of employee benefit consultants and attorneys. Treasury regulations in the past have clarified that a VEBA could not provide "a pension or annuity payable at the time of mandatory or voluntary retirement, or a benefit that is similar to the benefit provided under a stock bonus or profit-sharing plan. For purposes of section 501(c)(9) and these regulations, a benefit will be considered similar to that provided under a pension, annuity, stock bonus or profit-sharing plan if it provides deferred compensation that becomes payable by reason of the passage of time, rather than as the result of an unanticipated event." Treas. Reg. § 1.501(c)(9)-3(f). It is not clear whether the administration intends the proposed definition of "deferred compensation" to preclude the provision under a VEBA of medical or long-term disability beneifts which become payable upon the occurrence of an unanticipated event—sickness or disability. Care should be taken in drafting any redefinition of "deferred compensation" to continue the effect of the quoted regulation.

LONG-TERM DISABILITY BENEFITS

Testimony

Turning to long-term disability benefits—the administration has suggested that a reserve equal to 50% of three years' average benefit payments should be the maximum reserve under a VEBA. In order to properly match income and expense, the contribution level under a VEBA should match contributions with the value of incurred claims. Such a contribution level will build up a natural reserve of approximately 7 to 10 years of claim payments. This reserve is necessary so that the benefits of disabled members will not depend on future contributions. This is especially important if the VEBA is funded solely by employee contributions.

Finally, the administration has suggested that a benefit paid over more than the current and the next year is "deferred compensation" which cannot be provided under a VEBA. Long-term disability benefits must by their design be paid over a period of years and have historically been provided under a VEBA. The only way to provide such benefits other than through insurance is under a VEBA, which actually cuts the annual cost and tax deduction of the employer sponsoring the VEBA.

Background

In the early 1950s, an aircraft manufacturer was maintaining a VEBA to provide a source for long-term disability benefits. Because the assets of the VEBA were insufficient to cover incurred claims, the manufacturer had to step in and cover the short-fall. The manufacturer almost went bankrupt.

The administration has stressed the importance of matching expenses with the income generated by certain activities. Contributions to a VEBA providing long-term disability benefits are set actuarially so that they equal the value of the claims incurred in a particular year. Some actuaries would claim that even a reserve equal to 7 to 10 years of claim payments would not be sufficient for this purpose.

Section 501(c)(9) of the Code expressly permits a VEBA to provide sick and accident belefits. Treasury regulations state that "a sick and accident benefit includes an amount paid to a member in lieu of income during a period in which the member is unable to work due to sickness or injury." Treas. Reg. § 1.501(c)(9)–3(c). Such regulations clearly contemplate payments over a lengthy period of time to provide members (employees) a stream of benefits in lieu of income during a period in which the employee is unable to work due to sickness or injury, i.e., long-term disability benefits, and must contemplate an employer's ability to make provision for such payment when the disability occurs and the employee ceases working.

For larger employers, forcing them to insurance would produce in the long run greater premiums than the amount of contributions which would be necessary to fund the VEBA as described above. These greater premiums are due in part to an insurance company's administrative expenses (which are ordinarily three times greater than those associated with VEBAs) and the insurance company's profits. Employers which use VEBAs for this purpose incur a lesser cost annually and, therefore, pay greater taxes.

In the discussion of retiree health and medical benefits, we have discussed the possibility that the definition of "deferred compensation" as proposed by the administration will preclude the provision of retiree health and medical benefits under a VEBA and the provision of long-term disability benefits under a VEBA.

Finally, not all VEBAs are funded by contributions by an employer. One VEBA, for example, with which we are familiar covers 20,000 employees providing long-term disability benefits to employees and is funded solely from contributions by that group of employees out of after-tax dollars. That VEBA provides for continuation of half-pay for covered beneficiaries for a substantial number of years after incurring total and permanent disability. The average age of the employees is 38 years old. The employee contributions to the VEBAs are set at the same level as a commercial insurer would set for providing the insurance. A commercial insurer writes such insurance making provisions in its premium to pay all future benefit payments on claims incurred during the period for which the premium is collected. If the insurance company's premium is insufficient to meet those claims, the insurance company must draw on its general assets to meet the claims. The same level of employee contribution is critical in an employee-pay-all plan funded through a VEBA. Absent such level of contributions, the promised long-term disability benefits could prove illusory in future years.

Mr. **Pickle**. Thank you, Mr. Coupland.

And now our last witness in this panel is Mr. Russell Greenblatt of Chicago. Would you identify your company, Mr. Greenblatt.

STATEMENT OF RUSSELL E. GREENBLATT, ESQ., KATTEN, MUCHIN, ZAVIS, PEARL & GALLER

Mr. **Greenblatt**. Yes, Mr. Chairman. I am a practicing attorney licensed in Chicago, Ill., with the firm of Katten, Muchin, Zavis, Pearl & Galler. I am sponsored by the Ad Hoc Committee for Responsible Tax Policy.

Thank you for the opportunity to testify this afternoon. I would like to inform you that between 1978 and 1980, while with the Office of Chief Counsel to the IRS, Exempt Organizations and Employee Plans Division, I was the principal author of the proposed

Treasury regulations under section 501(c)(9) which were issued in 1980.

For the last 5½ years, my practice has been limited almost exclusively to VEBA's. I have implemented over 100 plans and have worked extensively with and advised numerous other professionals throughout the country with regard to the implementation of VEBA's. I have also lectured extensively on this subject, including at the NYU and USC Institutes.

I have submitted for your consideration an extensive written analysis of the joint committee's proposals. I share the concern of the joint committee with regard to recent abuses in the VEBA area. However, I believe that the IRS currently has sufficient authority to regulate the VEBA area and therefore, I believe that the only legislation that should be enacted currently, pending a more comprehensive study by the Treasury Department, is that needed to combat the acknowledged abuses.

While there clearly are certain abuses of VEBA's, the vast majority of VEBA's in existence today have been around for many years and provide essential employee benefits on a nondiscriminatory basis. I believe the proposals of the joint committee would have a substantial negative impact on these VEBA's and that this negative impact has not yet been fully analyzed.

Therefore, if any VEBA legislation is to be adopted at this time, I urge that it incorporate only those aspects of the Joint Committee's proposals which relate to clearly abusive VEBA's and that the Treasury Department commence a more thorough analysis of this area.

It is my opinion that there are four obvious abuses that can and should be corrected by legislation. First, the proposal refers to VEBA's which are established, generally by professional corporations, to provide recreational facilities to employees or scholarships to their children. Legislation should be enacted to clearly prohibit any future VEBA's of this nature.

Second, concern has been expressed regarding VEBA's which are discriminatory either in design or operation, primarily by small corporations. Legislation should be enacted to apply stringent participation requirements to VEBA's similar to those applicable to pension plans and to require benefits to either be equal for all employees or else proportionate to compensation, depending upon the type of benefit.

Third, VEBA's should be required to be formally recognized by the IRS as qualified as a condition to the deductibility of contributions. This would thus require the submission of applications by those plans which are of questionable propriety and which currently do not even submit applications to the IRS.

Fourth, an actuarial certification should be required as a condition to the deductibility of contributions which are accumulated within a VEBA as its reserves. While I agree with the joint committee's point that it is an abuse to claim a deduction for advance contributions to a VEBA, I do not believe it is inappropriate to permit deductions for contributions which are necessary to maintain reserves at a level determined by an actuary to be appropriate to cover the VEBA's outstanding liabilities.

Currently section 162 permits deductibility of contributions to a VEBA only to the extent they constitute ordinary and necessary business expenses and are made on an actuarially sound and level basis. My recommendation to require actuarial certifications would also alleviate the burden imposed on IRS auditors currently to determine whether the contribution exceeds the level permitted by section 162.

The joint committee proposal would tend to deny deductions until such time as the benefit is actually paid to an insurance company, employee or beneficiary. I believe that this would tend to discourage the accumulation of actuarially sound reserves, thereby resulting in underfunding and jeopardizing the benefits to be provided to employees covered by many benefit plans. In the event the sponsoring employer encounters financial difficulties,

Also of significance, is the role which VEBA's are frequently asked to serve in the reduction of health care costs to an employer. Many employers seeking to reduce their health care costs turn to self-insurance, and a VEBA is the natural vehicle through which such self-insurance frequently takes place.

In conclusion, I believe that by the adoption of certain specific changes to section 501(c)(9) an immediate end could be put to the vast majority of abuse in the VEBA area without having an adverse impact on VEBA's which provide employees with essential welfare benefits on nondiscriminatory terms.

Thank you.

[The prepared statement follows:]

STATEMENT OF RUSSELL E. GREENBLATT, ESQ., CHICAGO, ILL.

Thank you for the opportunity to provide you with my comments regarding the legislative proposals currently pending before the Committee. My name is Russell Greenblatt, and I am an attorney licensed to practice in Illinois and California. I am currently of Counsel to the law firm of Katten, Muchin, Zavis, Pearl and Galler, a law firm in Chicago, and have my own consulting company which consults exclusively in the VEBA area. I have also practiced as a certified public accountant with the firm Arthur Andersen & Company.

1. MY VEBA BACKGROUND

My experience in the VEBA area goes back to 1978, when I joined the Employee Plans and Exempt Organizations Division of the Office of Chief Counsel to the Internal Revenue Service. At that time I assumed responsibility for the preparation of Treasury Regulations for Code Section 501(c)(9). The Regulation Project had been opened in 1959, and for numerous reasons Final Regulations had still not yet been promulgated. Chief among the reasons was the fact that there were many different types of companies utilizing many different types of VEBAs to provide an ever-increasing array of fringe benefits, and it was difficult to reach a consensus of opinion on all of these issues at the same time. On July 17, 1980, Proposed Regulations were issued, of which I was the principal author.[1] 242 comments were submitted by the public on these Proposed Regulations, a hearing was held by the Treasury Department, and the Regulations were finalized on December 30, 1980. The Regulations, as finalized, closely resemble the July, 1980 proposals.

Since leaving the Office of Chief Counsel in mid-year 1980, I have continued to specialize almost exclusively in the area of VEBAs. I have lectured widely on the subject to many local, State and national tax conferences, and have published four articles on the subject in major tax journals.[2] I have personally implemented over

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[1] 45 Federal Register 47872.

[2] Greenblatt, "New Prop. Regs. Expand Use of Voluntary Employee's Beneficiary Associations" 53 Journal of Taxation 210 (October, 1980); Greenblatt and Banoff, "Final Regs. Increase

Continued

100 such programs for corporations ranging in size from large publicly-held companies down to small professional corporations. The majority of my practice, however, does not concern the implementation of VEBAs for individual companies, but rather providing consulting services to "service provider" organizations who implement VEBAs for their clients. In this regard, I work closely on a day to day basis with numerous attorneys, actuaries, CPAs, insurance companies, banks and benefit consultants who are located in numerous states, and who implement a wide range of VEBAs for various types of companies. I would estimate that the people whom I advise have implemented approximately 200–500 VEBAs. Of the VEBAs which I have either implemented or assisted in the implementation of, I am aware of only two which have been issued adverse Determination Letters by the IRS which either have not been overturned or are being reconsidered by the IRS upon appeal.

II. LEGISLATIVE PROPOSAL CONCERNING VEBA'S

While the proposal raises several items of valid concern which perhaps should be addressed by the Committee, I believe that many of the points are overstated or otherwise do not warrant legislation. I believe that with regard to several of the points, legislation would be harmful. More than 20 years of work were required for the experts within the IRS to thoroughly analyze the area, receive comments from the public and the field offices, obtain approvals at numerous levels within the IRS and promulgate VEBA Regulations. I respectfully submit that any proposals which would be adopted at this time, without the benefit of a thorough study by the Treasury Department, consideration of the last 50 years of development in this area, and thoughtful comments by the public, would be precipitous. For example, almost every professional I have spoken to about the proposals, even as late as Friday, had not even heard about them. Furthermore, I urge you to consider the fact that legislation will require the IRS to prepare new regulations, and uncertainty will exist until such Regulations are promulgated.

A. Clarification of joint committee's "present law and background"

(1) Proliferation of VEBAs

(a) According to the IRS, the number of active VEBAs to which the IRS has issued favorable Determination Letters had increased from 7,791 on November 30, 1980 to more than 9,400 in January, 1984. While the percentages appear impressive, this amounts to less than 50 per month. The number of new VEBAs is probably too small to warrant enacting legislation which would substantially impact the thousands of VEBAs which have been in existence for decades. (b) Although admittedly many of the new VEBAs are being formed by professional corporations, it would be erroneous to assume that they constitute a large percentage of the approved VEBAs. Less than 10% of the VEBAs I have implemented are for professional corporations, and even those had to be desinged to give the rank and file employees a disproportionately large percentage of the benefits in order to obtain approval from the IRS. (c) Furthermore, the Joint Committee implies that the favorable tax treatment of contributions to VEBAs undermines the incentive of employers to maintain qualified pension plans, which are subject to more stringent requirements than VEBAs. I know of no case in the entire country where this was true, nor have I ever heard an attorney or other advisor ever imply that a company should adopt a VEBA in lieu of a pension plan.

(2) IRS approval of VEBAs

While figures were revealed of the increase in the number of VEBAs approved by the IRS, conspicuously absent are figures addressing the number of applications denied by the IRS. My guess is that far more VEBAs have been denied than approved by the IRS in recent years. Analysis of IRS records is likely to reveal that rejections were quite unusual in 1980, whereas today adverse IRS Determination Letters are the order of the day. While the Joint Committee maintains that VEBAs are subject to far fewer restrictions than pension plans, the Committee would likely find startling a comparison of the percentage of VEBA applications which have been rejected in the past year with the percentage of pension plan rejections. I am inundated with requests to handle appeals for cases which have been issued denial letters by the IRS despite the taxpayer's honest efforts to comply with the Regula-

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the Attractiveness of Voluntary Employees' Beneficiary Association," 54 Journal of Taxation 194 (April, 1981); Greenblatt and Banoff, "Corporations can reduce the after-tax cost of fringe benefits through VEBAs." 28 Taxation for Accountants 366 (June, 1982); Greenblatt and Bernstein, 41 New York University Institute on Federal Taxation, Chap. 36 (1983).

tions. My point is that the IRS has already regulated the field administratively. The language of the Regulations is loose enough for the IRS to take a strict enough interpretation to effectively discourage companies from implementing all but the most innocuous VEBAs. restraint by the IRS should also be required if there is to be any predictability to this area; therefore, any legislation which you consider should give clear guidance to the IRS regarding which VEBA cases to approve and which to obey.

(3) Types of VEBAs being implemented

It has been implied that the VEBAs which are being established are intended to either provide extravagant benefits such as ski chalets or yachts, or else to provide discriminatory benefits to the key employees. While it is true that a number of such abusive VEBAs have been and are being formed, particularly by very small professional corporations, fewer and fewer new VEBAs of this type are being implemented. While some promoters of recreational facilities have strenuously marketed "ski lodge VEBAs", the number of such programs actually implemented is *de minimus.* Much ado is also made about *Greensboro Pathology Associates, P.A. v. United States,* 698 F.2d 1196 (Fed. Cir. 1982), a court case in which the employees' children's scholarship fund established by a doctor corporation was held to be a welfare benefit plan rather than a deferred compensation plan. That case did not involve a VEBA, and to my knowledge the IRS has never approved such a program as a VEBA. That type of scheme was well-known back when we were drafting the VEBA Regulations, and the Regulations were consequently written to prohibit such a plan from being implemented in a VEBA.[3] Therefore, the *Greensboro* case is not an issue. The proposal fails to acknowledge that the vast majority of approved VEBAs are quite innocuous, and have been formed over the past several decades by medium-sized or large companies in an attempt to lower their welfare benefit costs by self-insuring their medical and/or disability benefits. I am personally aware of less than a dozen VEBAs which have been approved by the IRS in the past year for professional corporations. While it is true that numerous articles have been written expounding upon the virtues of VEBAs in glowing (and general) terms, there has been substantial discussion, particularly of late, concerning the problems, pitfalls and dangers of VEBAs. If the Committee perceives an abuse with regard to particular types of VEBAs, then the inquiry and legislation should be aimed at them. For example, the Joint Committee's pamphlet makes reference to *Greensboro* scholarship benefits and "ski lodge VEBAs," but makes no legislative proposal with regard to either of them. Any legislation should specifically address such plans, making it clear that *Greensboro* benefits cannot be provided through VEBAs and that no new ski lodge VEBAs can be formed. With regard to this latter point, I urge you to "grandfather in" VEBAs which have already acquired or begun construction of facilities which are modest (as opposed to extravagant), utilized by a substantial number of employees, etc. Otherwise, they will be penalized for having established such a VEBA at a time when they were permitted to do so.

B. Discussion of issues

(1) Treatment of employer contributions

The issue raised for consideration is whether it is appropriate to permit "favorable" tax treatment for employer contributions to VEBAs, when in some cases the benefits provided by the VEBA are favorably treated in the hands of the employee. This implies that (a) the employer is currently being treated "favorably", and (b) just because Congress has previously decided that employees should not be taxed on some fringe benefits, such as the providing of medical coverage, the employer should not be encouraged to seek the cheapest way for it to pay for that benefit, such as by self-insuring.

(a) Employers do not get "favored" treatment; proposal regarding actuarial certifications. Employers are not given "favorable" treatment for contributions to VEBAs; rather, they receive tax deductions for benefit expenses which are paid to the Trust, to the extent such contributions are actuarially-sound and made on a level basis.[4] The deduction must also be an ordinary and necessary business expense (Treas. Reg. § 1.162-10), and not constitute unreasonable compensation when added to the other forms of compensation provided to the covered employees. In addition, in order for the VEBA to be qualified, the employer must be precluded from ever being able to recapture the contribution (or earnings of the VEBA), or otherwise having the

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[3] See, Greenblatt, "New Prop. Regs. Expand Use of Voluntary Employees' Beneficiary Associations," Note 2 at p. 212.

[4] See, e.g., Revenue Ruling 73-599, 1973-2 C.B. 40, and several dozen Private Letter Rulings.

VEBA's assets inure to its benefit. VEBAs are also subject to the restrictions and safeguards of ERISA, with regard to reporting, disclosure and fiduciary responsibility. They also are subject to tax under Code Section 512(a)(3) if their asset accumulation is not reasonable. (See also Internal Revenue Manual Exempt Organizations Handbook, Section 9(11)0.) Consequently, I believe that new rules are not needed; rather, the existing and well-accepted rules need to be carefully examined to see how they should be applied go VEBAs, and need to be administered by auditing agents. To the extent the proposal has raised the question of the actuarial soundness of some VEBAs, I believe it is beneficial. For example, the Actuarial Division of the IRS should be playing a more active role in examining VEBAs to determine if the contributions are actuarially-sound. The analysis should focus on each type of benefit plan, how it is funded, insured, etc., and determine the actuarial propriety of the funding. Perhaps actuarial certifications should be required of all VEBAs which "self-insure" benefits and which seek contribution deductions for additions to their reserves, as is true of pension plans. A requirement of this nature is appropriate because it would take into account the particular facts of each particular type of plan. Upon audit, IRS agents should more carefully examine to ascertain whether the contribution was an ordinary, necessary and reasonable business expense, made on an actuarially-sound and level basis. This point has recently been recognized by the IRS, as evidenced by the new form of Determination Letter which addresses this point and which emphasizes that the Determination Letter is addressed to the Trust's exempt status and not the deductibility of contributions. A requirement of an actuarial certification would effectively eliminate the abusive or overfunded VEBAs, and would also ease the burden placed upon the IRS' audit staff.

(b) Cost containment and the appropriate level of reserves are unrelated to the tax impact to employees.—The fact of excludability from the employee's taxable income of certain statutory fringe benefits should not have an impact on whether or not the employer gets a deduction for the providing of such a benefit, or the timing of the deduction. In this age of sprialing health care costs it would be counter-productive to restrict the options available to an employer seeking to lower its costs. If an employer determines, based upon the recommendation of actuaries, insurance consultants and others, that the self-insuring of an employee health benefit such as medical, death or disability benefits would lower its actual out-of-pocket costs, then the employer should be given tools and vehicles through which to effectuate this savings. The proposal has a deleterious effect on the employer's inclination to provide conservative or secure reserve levels; thereby jeopardizing the employees' benefits. Faced with the possibility of having the deduction for its contribution denied unless the amount falls within arbitrary guidelines, employers will opt for the more secure route of understanding their VEBAs, thereby defeating the purpose of the VEBA. If the deduction is denied until the time the employee is actually paid the benefit, what incentive would an employer have to fund the benefit to provide security to the employee? For example, the proposal appears to approve of the providing of post-retirement medical and life insurance benefits. Why would an employer fund such a benefit if he was denied the deduction until the employee retired, financial acounting principles which require the employer to recognize this expense ratably over the employee's working career? Even if Treasury Regulations providing "safe harbors" were to be promulgated, query whether they would come soon enough or be sufficient.

Additionally, percentages as suggested by the proposal frequently make no sense in the case of new VEBAs which have no prior experience, or which provide benefits the claims experience of which is subject to wide vascillations. In the early years the amount of benefit payments tends to be much lower than will be true in later years or more for more mature plans. Any legislation should take this into account, as well as anticiapted inflation, since reserves are accumulated with the purpose of making the benefit payments over the next few years, not the past few. Legislation should also require VEBAs to discount their reserves to take into account expected investment earnings between the date the reserve is being evaluated and the date of expected benefit payment(s).

Also consider the case of companies which have partially self-insured death benefit VEBAs. To limit the size of their reserves to 50% of the average annual benefits paid during the preceding 3 years would be suicidal. Even if the proposed 50% safe harbor is 10% greater than the average VEBA reserve (in 1980), it is likely that different sized reserves are more appropriate for different types of plans. For example, disability plans typically have a long payout period, and therefore their reserves should be larger on a percentage basis than that of medical plans. This is truly an area in which arbitrary rules should not be enacted precipitously. If percentage reserves are adopted, I strongly urge you to define permissible reserves as being a function of total costs, including insurance premiums, but perhaps excluding administrative fees. Otherwise, the size of a VEBA's reserve would be affected by whether it had been insured in preceding years.

(c) Limitation of deduction to the amount includible in income.—The proposal keys the amount of deduction into the portion of the contribution that is includible (or would be includible) in the gross income of employees during the year. Many VEBA plans maintain fiscal years different than that of the sponsoring employer, which results from the VEBA having been originally established in a different month or keyed into the anniversary date of insurance contracts. This is particularly true where a VEBA covers the employees of more than one employer, or where it is collectively-bargained. Which "year" is to be utilized for purposes of the deduction? Assuming flexibility is permitted and that it may be either the company's fiscal year ending within the VEBA's trust year or the VEBA year which encompasses the company's yearend, the company appears to be "at risk" to guess what the expenses will be. In the typical scenario, the company funds its VEBA for the anticipated expenses, taking into account anticipated premium rates, increases in the labor force, etc. I suggest that the deduction rule not be applicable to cases where the VEBA is independent from the employer, such as where it is run by the employees or is formed by an independent entity, such as a trade association or at the behest of a labor union. In such cases, where it can be said that the contribution is really a payment to an independent entity, the deduction should be permitted as long as the contribution does not result in an asset with a life substantially beyond the end of the employer's fiscal year. A safe harbor should be provided for amounts which will be spent by the VEBA by the end of its fiscal year.

(d) VEBAs do not detract from pension plans.—Another point raised in the pamphlet is that consideration should be given to the question of whether the availability of deductions for contributions to welfare plans reduces the incentives for employers to maintain qualified pension plans, which it is argued must satisfy far more restrictions intended to protect plan beneficiaries. In 5½ years of specializing in this area, I know of no case in the country where a VEBA was chosen over a pension plan or was the incentive to discontinue a pension plan.

(e) Depreciable property.—The proposal would limit employer deductions to the year in which the particlar benefit is provided to the employee. If the expenditure is for a depreciable asset, the benefit would be considered to be provided in an amount equal to the deduction generlly allowable for that type of asset for that year. I believe that a contribution to a VEBA of a depreciable asset, such as a piece of recreational property (assuming naturally that the purpose of the VEBA is to provide recreational benefits), is not as closely monitored as it should be. Without any control, this area is subject to abuse. Controls do exist—they are just not being administered to their fullest extent.[5] For example, the contribution of property to an ERISA trust is likely to be considered a prohibited transaction under ERISA.[6] If, instead, the employer contributed cash and the VEBA purchased the property, why limit the deduction to the depreciation schedule of the propery when the deduction for the initial contribution was already regulated? In other words, the employer must already justify the deduction on the basis of an ordinary, necessary business expense funded on an actuarially-sound, level basis. This rule already embraces the "matching" concept of spreading the cost out over the relevant period. However this issue is ultimately resolved, it would be generally acknowledged that the employer is receiving "favorable" treatment if the cost of the facility can be deducted in full in the first funding year.

(2) Severance pay and supplemental unemployment benefit plans

Under the proposal, benefits payable by reason of separation from service could not be paid to employees if the sponsoring employer has a qualified pension and/or profit-sharing plan whose benefits are set at the maximum dollar limitations applicable to qualified plans.

(a) Severance plans versus qualified pension plans.—Presumably Congress has already addressed the subject of the appropriate level of retirement benefits which employees should be provided. VEBAs frequently provide severance benefit plans which pay a known dollar amount in the event of an unanticipated event, such as a strike, being fired, or the company going bankrupt. The purpose of the severance benefit is generally to tide employees over between jobs or to give them job readjustment allowances, training benefits, etc., which is entirely different than the purpose of a retirement benefit. Therefore, careful thought should be given to the policy

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[5] But see, *Termicold Corporation* v. *United States,* 83-1 USTC ¶ 9350 (Ct. Cl. 1983).

[6] Department of Labor Advisory Opinion 81-069A.

behind each before they are integrated. I do not have a recommendation as to whether the payment of severance or unemployment benefits should be permitted by VEBAs. It seems that such benefits should be permitted, at least to younger employees who would not receive sufficient retirement benefits to tide them over in the event of unanticipated termination. I believe, however, that more time is needed to study this subject.

(b) Severance plans are already regulated.—Department of Labor Regulation § 2510.3-2b, as expanded upon by DOL Advisory Opinions, regulates and distinguishes severance plans from pension plans.[7] The VEBA regulations were written to incorporate in this distinction, and permitted VEBA severance plans were therefore defined by reference to that DOL Regulation.[8] It is believed that this subject lies under the jurisdiction of the Labor Department, as further evidenced by the mandate contained in the Multiemployer Pension Plan Amendments Act of 1980 (Section 409), and that the Labor Department should be given the opportunity to study this subject and give the Committee its recommendations.

(3) Nondiscrimination rules

I believe it is appropriate to impose nondiscrimination rules upon VEBAs, but such rules are already present in the existing Regulations. It is stated that the VEBA rules are more lenient and suceptible to abuse, but in fact the IRS routinely denies qualified status to a startlingly large percentage of VEBAs based solely upon applying the smell test. It is agreed that guidelines would be helpful, but arbitrarily imposing a percentage of benefits test is inappropirate in an area where the benefits are not "predictable". Even if it could be determined how to measure who was to receive how large a recreation or training benefit (especially if the VEBA provides several different types of benefits on different bases, such as equal medical coverage but life insurance which is based upon an employee's compensation), what if fortuitous events occurred during the year? And why should the arbitrary percentage limitation be the same for each type of benefit? Would it be permissible for a VEBA to exceed the proposed 25% limitation if the highly compensated employees had paid for the increased benefit by choosing higher benefit options and contributing more money that particular year? What if they received 30% of the benefits, but had made 50% of the contributions? How will "highly compensated" be defined? What happens to existing plans, where the benefit plans orginally implemented and approved by the IRS happen to exceed the limitations imposed by the proposals? The dissolution restriction provision of the proposal would appear to be retroactive legislation if it is applied to existing VEBAs. For example, the new percentage test may result in the VEBA not being able to continue as a qualified VEBA, yet may at the same time dictate that it must comply with the percentage liquidation guidelines, thereby resulting in a windfall to the nonhighly compensated employees.

(4) Unreasonable penalty provision

The Proposal contains an unreasonable penalty provision. In the case of a VEBA which loses its tax-exempt status, for apparently any reason, the highly compensated employees must include in income as ordinary wages any benefit which they are provided, even if there is a statutory exclusion from income for such benefit. For example, assume a VEBA which provides for the reimbursement of medical bills on an equal basis to all the employees of a company which is owned by an investor who subsequently personally purchases a second company unrelated to the first. By virtue of the owner not providing the employees of the second company with the same benefit, the highly compensated employees of the first company run the risk of having to report the medical payments in income, even though they never even knew the second company existed. The highly-paid employees who may be in the worst medical condition, i.e., the ones with prolonged illnesses, are the ones who have to include the hospital bill payments in income even though they never saw the money and therefore are unable to pay the tax. I believe the penalty is being applied to the wrong person, and does not match the crime (if a crime can be said to have occurred). An employee who has not involved in the transaction which resulted in the loss of qualified status, whether or not he or she is highly-paid, should not be penalized. Loss of tax-exempt status appears to be more appropriate remedy, since its financial impact would ultimately redound to the detriment of the owner of the company.

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[7] See, e.g., Department of Labor Advisory Opinions 83-47A; 82-43A; 81-55A.

[8] Treas. Reg. § 1.501(c)(9)-3(e).

(5) Benefits which are equivalent to wages

If the payment of a benefit is contingent only upon the performance of additional services by the employee, it will be considered "equivalent to wages" and will not be a permitted VEBA benefit. The example of vacation pay is given, and presumably sick pay would be similarly treated, even though each is provided as a means of safeguarding the employee's health or protecting against the interruption of work. This aspect of the proposal is somewhat confusing, since vacation plans frequently require more than the providing of additional services—they require the taking of a vacation, which is presumably beneficial to the employee's health. This aspect of the proposal is directly contrary to the Regulations and historical practice in the area.[9] Being contrary to accepted practice, however, should not preclude the "tightening up" of this aspect of VEBA's operations. If properly defined, this proposal is probably a good one. Time should be taken to analyze this area in more detail though, particularly with regard to those plans already in existence which provide this type of benefit, including numerous collectively-bargained VEBAs.

(6) Miscellaneous additional issues

(a) Limitation on the percentage of benefit provided to the members of the prohibited group.—What if a substantial percentage of the employee population owns stock in the company (i.e., an ESOP) or is highly compensated: does this mean the company cannot sponsor a VEBA because the percentage test would certainly be violated? How can you monitor the question of who is "highly compensated"? For example, if an employee gets a large bonus, then in order to not violate the "top heavy rule" the VEBA may have to deny him his medical benefits (assuming the VEBA is able to determine whether or not he has become a member of the prohibited group as a result of the bonus). What if he is a member of the "prohibited group" for the year because of his yearend bonus, but his medical bill was paid early in the year? Should the VEBA obtain repayment from the employee in order to avoid disqualification?

(b) VEBAs already in existence.—How does a VEBA avoid disqualification if it already has been approved by the IRS to provide severance pay or vacation pay and the terms of the trust contain provisions which restrict the employer's right to amend or terminate the VEBA? (Such provisions have been used on occasion to appease the IRS in the qualification process, by prohibiting the controlling employees from amending the plan after qualification.) For numerous reasons, any new rules should only be applied to VEBAs not yet formed. Limiting this "grandfathering" to VEBAs which have already been approved would be unfair because the IRS has a backlog of cases to rule upon which may have been pending for months. Perhaps any "grandfathering" should be applicable only to VEBAs actually implemented by the date a Bill is proposed and who also submit applications to the IRS within a limited period of time after passage of the Bill.

III. CONCLUSION

While the Proposal raises a number of issues which need to be addressed, I do not believe the appropriate resolution is a legislative one at this time. In most cases the rules already exist, they are just not being followed or applied. The plethora of tax articles is misleading because while the articles lead one to believe that such plans are proliferating, in many cases the articles are merely hypothetical. The number of cases in which such plans have actually been implemented and approved by the IRS is small, and certainly does not justify a massive rewriting of the law as it applies to all VEBAs. It took over twenty years of careful consideration for the IRS to promulgate the existing Regulations, and employers and VEBAs are just becoming comfortable with them. I believe that before responsible legislation of a far-reaching nature can be enacted in this area, it would require at least a year of study by the Treasury and Labor Departments and input from the public.

I would be happy to discuss these comments in more detail with you or your staff or otherwise work with you to implement reasonable rules.

Mr. PICKLE. Thank you, Mr. Greenblatt.

Mr. Gibbons, we have asked that the statements of all of these witnesses be included in the record, and this completes this particular panel.

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[9] Treas. Reg. § 1.501(c)(9)-3 (d) and (e); Rev. Rul. 57-316, 1957-2 C.B. 626.

I think I will ask one general question of any of you, because I have an article here which raises a question in my mind. Recent articles have indicated that VEBA's are being used to avoid the qualified plan limitations of TEFRA. How would you respond to that, if you agree or disagree; and what would you suggest we do to prevent this if it is being practiced?

Do you think it is being practiced to avoid TEFRA?

Mr. **Don**. I cannot speak for everyone, but we have not seen anyone who has done this, nor have I in my consulting practice even heard any hint of anyone attempting it. Frankly, I do not see VEBA as an effective vehicle for doing it.

Mr. **Pickle**. Does anyone think it is being used now to avoid TEFRA? Mr. Swanke?

Mr. **Swanke**. I do not think TEFRA has had enough time in history to have been invaded by VEBA.

Mr. **Pickle**. Mr. Greenblatt, you seem anxious to comment.

Mr. **Greenblatt**. Yes, Mr. Chairman, thank you.

First of all, the implication is made in the proposal that somehow or another making VEBA's available will tend to discourage the creation of qualified pension plans and the safeguards to employees contained therein. I have never heard of a single case in the country where a VEBA was implemented in lieu of a pension plan or where it was an incentive to eliminate or discontinue such a plan.

Second, I would like to point out that, while there are statistics contained in the Joint Committee report evidencing the great proliferation of VEBA's in recent years, there is conspicuously absent any reference to the tremendous percentage of VEBA's which are disqualified by the IRS for failure to comply with very, very stringent requirements with regard to participation and eligibility and benefits.

Mr. **Pickle**. Now, Mr. Greenblatt, again I quote from the Financial Planner, which I presume is primarily your bible or whatever you want to call it. It says: "VEBA is the planner's response to TEFRA limitations."

In a very prominent article—September of 1983—it points out that when TEFRA was passed that a lot of you objected to that because you said it had a negative influence, and these are qualified limitations. Then it says "For the employer wishing to provide fringe benefits to himself and to his employees, there can be no better vehicle than the VEBA."

Then it goes on to explain how you qualify, the employees would include, the employer's wealth not over 10 percent, and so forth. And then it gives an example of salaries, and it starts off with doctors, one doctor making $200,000 and another doctor making $150,000, and the manager receives a salary of $18,000 and another one $12,000, and so forth, right on down the line.

And then it says, even with all of that, even with TEFRA, you may have some extra money. But it says, you take advantage of a VEBA, you can avoid TEFRA. It says: "In this instance a VEBA provides an excellent vehicle for allowing the doctors to accumulate additional funds without regard to the TEFRA limitations on contributions or to the accumulated earnings tax."

Now, it seems to me like that is a strong advocacy that you can use VEBA's to avoid these limitations under TEFRA. How can you put another interpretation to it, or do you not agree with this article?

Mr. COUPLAND. Mr. Chairman, there is a practice that has developed over the years, that started under section 501(c)(9) and then finally became part of section 501(c)(17). I do not speak to the wisdom of that practice, but it is dealing with what is called supplemental unemployment benefit plans that are sponsored by a large variety of very large, collectively large unions: UAW, Steelworkers, and others.

The plans generally speaking under 501(c)(17) provide benefits upon layoff, not upon retirement. Section 501(c)(17) contains a significant restriction and that is that, if the section 501(c)(17) plan provides a separation payment upon layoff, it cannot also provide the same or any separation payment upon death prior to the date on which the person becomes eligible for the separation payment.

In response to that restriction a number of unions have requested that employers establish a 501(c)(9) organization to cover supplemental unemployment benefit payments and provide a death benefit. We view that as being the basic erosion that led to providing severance payments under 501(c)(9) plans which is being referred to in the article that the chairman quotes.

There is an easy solution to that. Section 501(c)(9) lists "life, sick and accident, benefits" by its express terms as proper benefits to be provided by a section 501(c)(9) plan, and then it adds the term "or other benefits." Within that term—"or other benefits"—are encompassed such concepts as the vacation homes, vacation pay, and other things.

We can see a way through this by simply moving the death benefit feature of a supplemental unemployment benefit plan to section 501(c)(17) and permitting section 501(c)(17) to provide that death benefit.

Mr. GREENBLATT. Mr. Chairman, may I add a comment, please? I believe one of my four recommendations would get at the abuse to which you referred in that particular article, which many of us hardly consider our bible. My recommendation was that applications be required to be submitted by such organizations so that the IRS must formally recognize it as qualifying under section 501(c)(9). That is the way Congress handled the 501(c)(3) area.

If an application was submitted for the association that was referred to in that article, it would unquestionably be denied by the Internal Revenue Service, and such associations as referred to therein have been denied quite unanimously by everyone in the IRS within the last year.

Mr. PICKLE. Well, I will read your testimony again, Mr. Greenblatt. Perhaps it will. But with these articles, we cannot help but observe that publication after publication—here is one, the Estate Planning Journal of last fall—points out that a VEBA is one way to avoid these limitations.

It is disturbing when you read literature which says, a section 501(c)(9) trust for the employee providing current life insurance benefits on a self-funded basis may accomplish many of the objectives previously sought in a highly leveraged defined pension plan, in other words, how you previously could shelter large sums of corporate income from taxes.

When we read this, and see that you are trying to sell these things, we come back to the conclusion, that, you are more interested in avoiding taxes and giving fringe benefits than the benefits that actually go to the employees. I am not accusing you of that, but I say there must be a balance on it. If you do not, then you are going to change the whole concept. I do not know that I think the IRS recommendation does that much damage to you. It may be that this is such a problem, Mr. Gibbons, that we may want to consider this more, but these gentlemen submitted very important testimony, and I think it ought to be made a part of the record.

Mr. GIBBONS [presiding]. Mr. Pease, do you have any questions?

Mr. PEASE. No, Mr. Chairman.

Mr. GIBBONS. Let me throw a bombshell out there for you all to wrestle with. I do not think there is any excuse in the world for your industry, except it is a good way to get around the Tax Code. You would be just as well off paying employees what they are worth and let them go out and spend their money like they do, like they want to, except they would have to pay social security taxes, and they would have to pay some income taxes.

Now, the people from the Federal Reserve say in 1950, 12.6 percent of all compensation that was paid to people was in the form of group benefits. In 1983, it is up to almost 30 percent. It is just another way of avoiding paying your fair share of taxes. Most of the benefits go to the higher paid employees, and I think you all are just hanging on the tax system here. Now, fight with that one for a while.

Mr. ASKINS. May I be responsive to that one, sir?

Mr. GIBBONS. Go right ahead.

Mr. ASKINS. The specific area that I am most vitally interested in is medical benefits for retirees. The only vehicle that we know of to provide that kind of a benefit is through a VEBA. Now, consider your statements on the kind of objectives that the corporate taxpayer is seeking, and compare those objectives with retirement benefits.

Mr. GIBBONS. Are these rank and file employees?

Mr. ASKINS. Absolutely. In White Motors' case, over 4,000 rank and file employees, retirees.

Mr. GIBBONS. Hourly employees?

Mr. ASKINS. Yes, sir, hourly and salaried rank and file employees who have provided 20, 30, 40, and in some cases 50 years of service to a corporation, who are uninsurable because of their age and health, and who can be provided these benefits through a VEBA. If we destroy that, we destroy a significant social benefit in this country.

Mr. GIBBONS. OK. Well, that is—let us agree that I may be wrong in that case. Now, what other reason is there for the existence of your industry?

Let me yield to Mr. Pease first.

Mr. PEASE. Before we leave health benefits for retirees, I believe the gentleman said that these retirees would be uninsurable. What is wrong with medicare and all of the supplemental Blue Cross policies and other things that are available to anybody who wants them?

Mr. **Askins**. Mr. Pease, regardless of advertisements on TV, if you have a preexisting condition when you are terminated by your employer, retired, or whatever, if you have terminal cancer, you will not be able to obtain insurance, or if a dependent member of your family has such a disease, you will not be able to obtain coverage for that individual. It is the employer sponsored retiree health program that I am talking about that protects individuals against catastrophe. That is not obtainable anywhere else.

We are talking about individuals who were promised by a company that they would have lifetime medical coverage after they retire from the company, if they make their commitment to the company and work until retirement. The employee does that. Then the company goes bankrupt, or the company decides to terminate the plan and say, well, we are not going to do that any more.

That employee has sacrificed a life and is now seriously ill. He is not insurable because it is a preexisting illness. The employer renegs on his promise, or is forced to reneg through financial difficulty in a chapter 11 or 7 bankruptcy. That individual has no protection. A VEBA is the only way to give him that protection.

Mr. **Pease**. Of the 4,000 people that you mentioned before, what percentage would be uninsurable?

Mr. **Askins**. I cannot answer that with an exact percentage. I could only talk about specific cases that have come to my attention where there has been involved a serious illness, for example a cancer situation. I could give you an estimate. It would be meaningless. I think the point is there are people within that 4,000 that that clearly applies to.

Mr. **Pease**. Well, there is no question about that. The question is whether we ought to be encouraging or permitting a system of taking care of everybody whether they need it or not in order to help out some people who admittedly have a serious problem.

Mr. **Askins**. I think the people that I am talking about, they are rank and file, not high wage earners who have retired, who are in a retirement income of some kind, a pension. In the *White Motor* case, because White Motor went into chapter 11, they are under a PBGC benefit, which in many cases is significantly lower than the pension benefits committed by the company.

They are on a reduced income. Even if they are insurable, their insurance costs can be very significant on an individual basis as they go to seek it. These are the people that I think we want to protect from long-term serious catastrophic illness in their retiring years. The vehicle that can give them that protection through funding so that they are assured that they will have that protection for their lifetime is through the VEBA.

Mr. **Pease**. Well, would you be in favor then of language which would restrict the use of VEBA's to people who are in the kind of dire economic straits that you describe?

Mr. **Askins**. I do not intend to speak for anyone other than myself. My experience is through White Motor. In that case, absolutely. That is the only vested interest I have.

Mr. **Coupland**. We are looking at two classes of employees, Mr. Pease. First, we are looking at those who are on long-term disability because they have incurred a substantial injury of some sort or have incurred a disability that has taken them outside of the work force.

In the retiree health area, we are looking at a very sizable problem, because as I mentioned in my comments, some of these estimates that we are looking at today—estimates made because in your district and others, in Ohio and elsewhere, large-scale shutdowns are occurring—as a plant is shut down, the company for the first time starts to look at what the value of its promise is, and as it looks at the value of that promise, it discovers that the value of its promise may be many times the company's annual profits before taxes or in excess of the company's net worth.

The Financial Accounting Standard Board is considering asking employers to bring that amount above the line onto the balance sheet for the corporation. There is no protection afforded to the employee by doing that, but at least it protects the investor. We are looking at something that covers the aluminum industry, the auto industry, the steel industry, the rubber industry, and many other industries, and at promises to provide lifetime benefits which are not backed at this time by an awful lot. As consultant to large employers and medium-size employers, we are saying that they had better back those promises with dollars. The place to back those promises with dollars is in the VEBA, and there is no other place that employers can do it.

In White's case, White tried to fully insure its promise of lifetime retiree health benefits. It was given quotations between from $90 to $110 million. White could find no insurer that was willing to write that insurance, notwithstanding the fact that the company is going out of existence. As a matter of fact, what White's employees received was approximately 25 million dollars' worth of benefits.

Mr. ASKINS. In a VEBA trust, and that is the way we solved that problem, or attempted to solve it for the employees or retirees of White. The only vehicle available.

Mr. PEASE. Thank you.

The chairman has been gracious enough to yield to me. I think I have abused his patience. Thank you, Mr. Chairman.

Mr. GIBBONS. Do the rest of you want to speak?

Mr. DAVIES. Mr. Chairman, my name is Ed Davies. I am the chairman and executive director of the Association of Private Pension and Welfare Plans. You asked the question of what is this industry just living off the Tax Code? I think when you are looking at employee benefits, you have to look at a number of things, and one of them is, how do these things develop, and they developed basically after World War II.

Mr. GIBBONS. They developed during World War II a way of getting around wage price controls.

Mr. DAVIES. Right, and the unions negotiated very strongly in this area to get around that, and as a result we have had sort of a hodge-podge.

Mr. GIBBONS. You know why I do not feel very friendly toward them. I had to get out there and get my fanny shot at while most of these fellows around here were getting fringe benefits, but go ahead.

Mr. Davies. I think what today we have been discussing, VEBA's, 401(k)'s, cafeteria plans, I think what it really boils down to in stepping back is that we really have got to develop a national policy with respect to employee benefits, and we have not done that. We have not looked at——

Mr. Gibbons. We have got a national policy. Thirty percent of all benefits now paid are outside of the tax system. Thirty percent of all the compensation is outside of the tax system, thanks to your vigorous efforts.

Mr. Davies. But also because Congress is shifting more and more burden on the private system in terms of reduction, in raising the retirement age in social security, shifting medicare costs over to the private sector, and what I am saying is, I think Congress has got to say what they want the public sector to do and what do they want the private sector to do, and what we are saying is, give us guidance and stability in terms of what are the benefits you want the private sector to provide their employees across the board.

And I think those programs have to run in tandem, and they have not been, and I think we have to look at what is it that Congress wants in terms of employee benefit programs both on the private and public side, and I think the private side has been neglected in terms of policy, and as a result, yes, abuses have developed, but I am saying most employers are trying to do this in good faith in providing across-the-board benefits, but Congress cannot every 2 years change the rules on the private side and expect to have stability in these programs. It is just not possible.

Mr. Hunt. Sir, we would endorse exactly what he said. He stole the words right out of my mouth. One of the things that is nice and I think would make it very clear is that we and you are in exactly the same situation. Looking in 1950 at the social security benefits that the Government offered, there were damn little, and today they have grown and grown and grown and grown, so the Congress is in the position of being a benefit plan administrator and benefit plan sponsor. There is concern today about everybody saying, why is social security a mess, why is medicare a mess. I know you have heard this until your ears were burning off about underfunding of social security. You and we are in the same situation. We both represent sponsors and administrators of employee benefit plans. We are trying to avoid the problems which you all have so ably pointed up, your problems in the funding of social security, I think Ed Davies is absolutely right.

We need a uniform national policy. That certainly comes back to what we were saying. We have the Department of Treasury saying one thing. We often have the situation as in the case of administrators where the Department of Treasury says to do one thing in a regulation, and the Department of Labor says, if you do that we will send you to jail, and the PBGC says, gee, that is not enough money.

This kind of confusion is what keeps me employed. I suppose I should not complain, but there is a drastic need for uniform guidance.

Mr. Gibbons. Well, suppose we got you back just to health insurance. What would happen? The only thing I have heard that you are willing to justify is health insurance for retired employees. What else can you justify?

Mr. DAVIES. Well, certainly a private pension plan.

Mr. GIBBONS. Well, can they not have a private pension plan under ERISA? Why do you have to have another private pension plan?

Mr. DON. Are you asking if this industry would exist if all——

Mr. GIBBONS. No, I am asking what is the justification for your industry other than to get around the Tax Code?

Mr. DON. We are not getting around the Tax Code. The Tax Code——

Mr. GIBBONS. If you are not getting around the Tax Code, then you are wasting your time and my time, too. We are only looking for taxes. Go ahead.

Mr. DON. Excuse me. The Tax Code says the group health, life, and disability benefits are not taxed to employees, with some minor exceptions. If the Tax Code were changed as has been suggested here to say that those benefits would be taxed, this industry will still exist. Group life, health, and disability benefits will still exist for reasons of administrative efficiency and for reasons of risk bearing. The fact that they are tax-free right now is not our doing. We are only living with the situation as it exists. If you change the tax laws, it will cut down the growth of the industry. It will probably cut down some benefits. But by no means will it eliminate this industry.

Mr. GREENBLATT. Mr. Chairman, I have noticed in recent years many companies have gone into VEBA's not as tax shelters but as a vehicle for lowering the cost to the company of providing these benefits, not only medical, but the decision whether to continue to pay premiums to a disability or life insurance carrier, or to lower the benefits by cutting out the profits to an insurance company, cutting out the commissions, cutting out the overhead.

Mr. GIBBONS. Suppose you all do a White Truck belly-up operation, and we pass it over to PBGC, which is just another—you know, what are we going to do if you all do that?

Mr. ASKINS. What we were suggesting is just the opposite, that if we encourage full actuarially sound funding of VEBA's, there would be no need for development of a PBGC for welfare benefits. In such areas as medical benefits and in disability benefits, it would be fully funded to protect those people who in fact are eligible for benefits without a PBGC-type fallback, even if the company does, as you say, go belly up.

Mr. GIBBONS. Well, are any of you advocating more than just group life and health insurance for the rank and file?

Mr. DON. And disability.

Mr. SWANKE. Mr. Chairman, as I stated earlier, we administer group health insurance, dental, disability, and vision under a 501(c)(9) trust, which is a VEBA.

Mr. COUPLAND. Mr. Chairman, I think those before you today would agree with you that if you are looking at accident, sick, and death benefits, those are appropriate benefits to be provided through VEBA. If you were to strike the words "or other benefits," I am convinced that those before you would be satisfied, and I say that because it is the term "or other benefits" in section 501(c)(9) that has in fact created the potential for abuse.

Mr. **Pickle**. You are recommending that it would be agreeble to you if we were to strike the words "and others?"

Mr. **Coupland**. Absolutely.

Mr. **Pickle**. Would anybody be in disagreement?

Mr. **Greenblatt**. Yes, a little bit, a minor disagreement, if you will. When I was drafting the regulations, I did a tremendous amount of research into the background of this area, and why the regs should be the way they are. There is one consideration which we have failed to address, and that is that union plans frequently negotiate for a contribution to a trust, Taft-Hartley, to provide certain benefits. It used to be you would contribute 3 cents an hour and you would get medical, and then 5 cents an hour and you got medical and life, and then disability, and then day care and legal service benefits, et cetera.

That is why the regulations are drafted in a manner which would provide and permit the additional benefits that would be distributed out of that trust, in the event the union had negotiated on behalf of the employees to have those benefits provided. The VEBA already has a tremendous reserve, and unless we permitted some of that money to be used to provide those other benefits, we would be in violation of the Labor-Management Relations Act.

It was a natural vehicle through which to continue to fund benefits. Just increase the contributions to the trust, a jointly administered trust representing employees and employers, and utilize that same fund, an actuarially sound fund, with collectively bargained contributions to provide all these benefits.

Mr. **Coupland**. I would like to suggest to the chairman that if that is the social purpose that we are going to serve, the easiest way to do so is to grandfather those plans, not for the purpose of future contributions, but for the runoff of those.

Mr. **Greenblatt**. I do not disagree with that.

Mr. **Gibbons**. Good, fine. I am sorry to throw you the bombshell, but sometimes that is the only way we can wade through all of this.

Mr. **Askins**. We enjoyed the bombshell. [General laughter.]

Mr. **Gibbons**. OK, fine. You are fine folks. I stirred you up a little. Go ahead, sir.

Mr. **Hutchings**. I would hope we would not lose sight of some of the testimony that has been advanced, which is essentially technical in nature and says that the formula for determining the permissible buildup of reserves would not deal with the full range within which health, life, and disability, would not deal with the full range of employee-sponsored needs in the programs that require reserves in excess of that formula, whether that be for post-retirement life and health benefits or disability life reserves, do need to be addressed. It is essentially a technical matter, but it is an important one within the framework of the agreement that we have found here.

Mr. **Greenblatt**. Mr. Chairman, it took over 21 years to write the regulations by the experts analyzing the area and the ramifications. One of the major points I want to make is that I really suggest that the major changes in this area of the law not be done overnight, but rather there be an exhaustive study by the Treasury and Labor Departments.

Mr. GIBBONS. We probably will not do them overnight. We will probably do them in early afternoon. That is the problem around here. But we are still haunted by the fact that in 1950, 12 percent of the compensation was paid in benefits, and now it is 30 percent of the compensation that is paid in benefits, which is just an erosion of the social security tax base, the income tax base, and everything else.

Mr. HUNT. Sir, it is the same for the taxes that we pay for social security, et cetera, et cetera. As I say, you and we are in the same situation, if you look at what was provided under social security in 1950. One of the things which I hear so often from our SPBA members is a feeling that they have been stabbed in the back. From about 1950 or so—and for some reason they seem to use that as a landmark * * *. They say that they kept feeling the pressure from government to provide womb to tomb security, and most of them were dragging their feet, saying, my God, there is some expense to this. In the middle of about 1979, everybody was told, gee, that is terrible that you are providing such good health benefits to people. It is too expensive. And I know a lot of our people, the employers and the employees, feel betrayed or doublecrossed in that situation. I know you find exactly the same thing when you proposed the social security cut. People say, you promised me this. They have learned to expect it—a raise.

And so we are talking about the psychology, and you and we share the same situation.

Mr. COUPLAND. Mr. Chairman, in back of the concept of ERISA was the concept that there was a complementary system of private retirement benefits that should and would be properly and adequately funded. We are looking particularly in the retiree medical benefits area at an area where if I were trying to write the law, instead of examining whether to cut back on the utilization of VEBA's, I would be looking at whether or not to create minimum funding in the area so that there was in fact adequate reserves and adequate benefits sitting back there, standing back of the promises.

Mr. GIBBONS. Obviously we should not be making hollow promises to anybody.

Mr. DAVIES. But the problem of post-retirement medical in the private sector, the liabilities there are enormous in terms of the promises that have been made and employers all of a sudden, given rising health costs, have said, my God, we had better start prefunding these programs in order to guarantee that those promises are going to be fulfilled, or we are really going to be faced with a problem.

Mr. GIBBONS. Well, we have a problem. We appreciate your coming. Thank you very much.

The committee is going to recess for 15 minutes and come back in 15 minutes.

[Recess.]

Mr. GIBBONS. Good afternoon, ladies and gentlemen, again. I hope everybody is refreshed and ready to go.

The next panel, the National Association of Home Builders, the National Realty Committee, the National Association of Realtors, the National Multi-Housing Council, the Coalition for Low- and Moderate- Income Housing, if you all will come forward. You are already here. Go right ahead. The National Association of Home Builders.

STATEMENT OF DAN GRADY, NATIONAL ASSOCIATION OF HOME BUILDERS, ON BEHALF OF JOHN KOELIMIJ, FIRST VICE PRESIDENT

Mr. **Grady**. Mr. Chairman, my name is Dan Grady. I am a home builder from San Diego, and I am appearing today instead of Mr. Koelimij, who was called out of town.

Mr. **Gibbons**. Mr. Grady, we are glad to have you.

Mr. **Grady**. Thank you very much, Mr. Chairman.

I am testifying today on behalf of the more than 118,000 members of the National Association of Home Builders, and we have a prepared statement which I ask to be included in the record.

Mr. **Gibbons**. Yes, sir, it will all be in the record.

Mr. **Grady**. Thank you.

This committee should realize that many so-called tax shelters are actually incentives to encourage activities which are socially and economically desirable. Tax incentives for rental housing are important because housing is essential to the economic recovery, and rental housing must be available to those who are unable financially or do not desire to purchase their own homes. Without tax incentives, rental housing just would not be produced.

The complexity of the provisions under consideration should not obscure these points. Rules governing special location and partnerships, at risk limitation, and depreciation for structures are incentives to encourage capital investment in real estate and housing.

NAHB has been one of the original advocates for reducing the deficit through a combination of spending reduction and broad-based tax increases. The commitment of NAHB's membership on this issue is strong and clear. NAHB's view of the direction which a bipartisan compromise on spending and taxes should take are as follows.

Domestic discretionary spending should be restricted. The growth in entitlement programs must be scaled back and deindexed. Increases in defense spending must be moderated. Appropriate tax increase that would not abort the recovery should be instituted. And finally, monetary policy should provide for sufficient expansion in the money supply to accommodate economic growth.

NAHB has indicated its support for several different approaches, including the Jones-Campbell scaling back of indexing, the tax-free approach of Chairman Rostenkowski and an income tax surtax and energy tax. NAHB opposes several extreme positions, such as the Democratic Study Group amendments, which would extend depreciation from 15 to 20 years and eliminate special partnership allocations.

We also oppose the 1983 proposals of the Treasury and the Senate Finance Committee and the change in the at risk rules as suggested as part of "other possible proposals" by the joint committee staff.

Tax benefits are a major means of making multifamily projects workable. Direct expenditures for housing programs have been virtually wiped out. During this decade, we estimate that more than six million new rental units will be needed to meet the demand. Nonsubsidized apartment production is estimated to be only 887,000 through 1984. This leaves an immense production shortfall for the next 6 years. Tax benefits are needed to meet this production shortfall.

NAHB is concerned that the focus of the Treasury's proposal for revenue raising is falling most heavily on the real estate industry. For example, $13 billion of the proposed $28 billion of additional revenues would be levied primarily from the real estate industry.

I wish to remind the committee, Mr. Chairman, that creation of partnerships is the major means of raising investment capital for the production of rental housing. Real estate just does not have the advantage of investment credit, which is often utilized by corporations.

NAHB wants to work with this committee in curtailing truly abusive situations. Detailed technical comments which we have developed with other members of the real estate community are included in appendix 2. NAHB is most deeply concerned about recommendations dealing with deferred payments and premature accruals. At current interest levels, for instance, it is necessary for new rental projects to defer payments of part of the interest charged by lenders until later years.

This has been clearly evidenced by the recent approval of HUD, Freddie Mac, Fannie Mae, and other agencies of graduated payment mortgages as they apply to rental housing. Income should not be taxed until it is actually received, and yet this would happen under the Treasury's deferred payment and accrual proposal, which extends the original discount rules to real estate transaction.

We believe that the Treasury itself recognized the inherent unfairness of the idea by exempting individual home sales and family farms. NAHB urges the committee to reject these Treasury proposals.

[The prepared statement follows:]

STATEMENT OF JOHN KOELIMIJ, FIRST VICE PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS (NAHB)

Mr. Chairman and Members of the Committee: My name is John Koelimij and I am a homebuilder and developer from Tallahassee, Florida. I am testifying on behalf of the more than 118,000 members of the National Association of Home Builders, of which I am First Vice President. NAHB is a trade association of the nation's home building industry. I am pleased to be here to testify on the legislative changes relating to tax shelters.

Accompanying me today is Robert D. Bannister, Staff Vice President of Government Affairs and Edward A. Beck, III, Tax Counsel for Government Affairs.

NAHB applauds the initiative which this Committee is taking in looking at the full implications of various legislative proposals dealing with what is known, for lack of a better term, as tax shelters. The term is unfortunate. It brings to mind the idea of tax avoidance and tax "loopholes" for the rich. In reality, many so-called "tax shelters" are basic incentives to encourage activities and promote investment behavior in a manner which is socially and economically desirable. For example, the tax code contains special provisions to encourage charitable giving, savings, economic growth and job creation.

Congress has for many years utilized the tax law to encourage investment in real estate. Although common to most real estate investment, tax incentives are important from a housing perspective because:

Housing means jobs. Housing is essential to the economic recovery. Multifamily, as well as single-family, construction has played a crucial role in the economic rebound and must continue to do so if the economy is to remain healthy.

Affordable rental housing is an essential part of our social policy today. Rental housing must be available for those who are unable financially or who do not desire to own their own home. Without tax incentives, rental housing would not be an attractive investment. Its availability would decline and the cost to the renter would increase.

The complexity of the provisions under consideration should not obscure these points. Rules governing special allocations in partnerships, "at risk" limitations and depreciation for structures have tremendous housing policy implications. Essential incentives to encourage capital investment in real estate and housing should be retained as part a national commitment for adequate, and affordable housing for all Americans.

In urging the Congress to retain essential incentives for investment in real estate, NAHB is mindful of the pressing national need to reduce the federal deficit. A reduction in the deficit through a combination of spending reductions and broad-based tax increases is NAHB's major legislative priority for 1984. The commitment of NAHB's membership on this issue is strong and clear. When offered the choice between "doing nothing, cutting domestic spending, and raising taxes," builders responding to a January 1984 Builders Economic Counsel Survey indicated that 93 percent favored cutting spending, 72 percent favored raising taxes, and only 4 percent favored doing nothing."

NAHB's view on the direction which a bipartisan compromise on spending and taxes should take are:

Domestic discretionary spending should be restricted;

The growth in entitlement programs must be scaled-back and de-indexed;

Increases in defense spending must be moderated;

Appropriate tax increase that will not abort the recovery should be instituted; and

Monetary policy should provide for sufficient expansion in the money supply to accommodate economic growth.

On the revenue side, many of the tax shelter proposals which have been discussed would fall most heavily on real estate investment. We believe this is the wrong direction to take. Tax increases should be both fair and broad based. The increases should be fair in the sense that they should not direct investment capital away from one sector of the economy towards another. Changes in 1981 favored corporate capital investment in machinery and equipment over real estate and housing. This bias should not be accelerated through additional taxes falling primarily upon real estate investment.

In terms of being broad based, NAHB has indicated its support for several different approaches. These include support for the Jones-Campbell scaling-back of indexing, the tax freeze approach which Chairman Rostenkowski has endorsed, and the income tax surtax and energy tax which was put forth in the Senate Finance Committee's November tax package. With regard to the specific tax shelter proposals which have been advanced, NAHB would be happy to work with this Committee and the Congress to make technical revisions to improve the efficiency of the tax law and curtail situations which may be considered abusive. Specific technical recommendations are continued later in my testimony. The proposals which the Administrative had advanced in its 1985 budget provide a starting point for these types of revisions.

However, NAHB would oppose several extreme positions which would radically affect the real estate industry and investment in housing. Specifically, the Democratic Study Group amendment would curtail essential housing investment by extending depreciation from 15 to 20 years and by eliminating special partnership allocations. The proposals in November which the Treasury and Senate Finance Committee developed, particularly limitations on special allocations under partnerships, would have a disastrous effect. Finally, a change in the "at risk" rules as suggested as part of "other possible proposals" by the Joint Committee Staff would adversely impact current real estate investment.

A copy of NAHB's policy which was adopted in January of this year on these issues is attached as Appendix I of the testimony.

The following testimony will explore these points in greater detail.

I. Tax Incentives and Housing

ECONOMIC RECOVERY

The present economic recovery can be characterized as primarily a housing-led recovery.

The following facts about housing's role in the economic recovery should be considered.

The housing industry led economic recovery throughout 1983. Although investment in housing only accounted for about 3.4 percent of the nation's real gross national product in 1983, housing was responsible for about 30 percent of total economic growth, or for $15 billion of the $50 billion real increase in real GNP experienced during the year.

1983 was the strongest housing recovery year since World War II. The approximately 1.7 million homes started in 1983 was a 60 percent improvements from the 1.1 million unit annual production level of 1981 and 1982.

A production increase of 641,000 homes in 1983 from the prior year created 924,000 man years of employment, $18 billion in wages and $8 billion in local, state and federal taxes. The first year of the housing recovery pumped $86 billion in new activity into the economy.

Rental housing is an important component of the overall housing start figures. Table 1 shows rental multifamily housing starts compared to total starts from 1981 through 1984.

TABLE I.—HOUSING STARTS

	1981	1982	1983 [1]	1984 [2]
United States:				
Total starts	1,084.1	1,062.3	1,703.1	1,754.2
Percent change	−16.1	−2.0	60.3	3.0
Rental apartments starts	221.0	258.8	359.0	345.6
Percent change	−20.8	17.1	38.7	−3.7
Subsidized	112,700	114,200	34,700	5,600
Nonsubsidized	108,300	114,600	324,300	340,000
Total	221,000	258,800	359,000	345,500

[1] Estimate based on preliminary data.
[2] NAHB forecast.

Source: NAHB Economics Division, Feb. 2, 1984.

Changes in the tax law which curtail current tax incentives for multifamily housing would have a dramatic effect upon this segment of the housing market. Tax benefits are a major means of making multifamily projects workable from an investment point of view. This is particularly the case since direct expenditures for housing programs have virtually wiped out. For example, new program activity under HUD assisted housing programs has declined from $26.7 billion in FY'80 to $6.2 billion proposed by the Administration for FY'85. And virtually none of the funds proposed for FY'85 would be available for new construction or substandard rehabilitation.

Tax benefits, therefore, often become a deciding factor in determining the feasibility of a new project. Rental income, particularly for low and moderate income units, often does not cover debt sevice. The ability to utilize tax benefits through limited partnerships to attract investors is a crucial element, if not the major deciding factor, in initiating a rental project. Drastic changes in rules for partnership allocations and the "at risk" provisions would sharply curtail this economic activity, thereby jeopardizing the overall economic recovery.

SOCIAL POLICY

NAHB is concerned about providing an adequate supply or rental housing for the future. This concern is particularly acute for low and moderate income housing. Moderate income families, especially those with children, and low income households face severe difficulties in locating suitable rental housing.

During this decade, more than 6 million new rental units will be needed to meet the demand created by rental household formation and meet replacement in vacancy requirements. Nonsubsidized apartment production is estimated to be 887,200 units cumulatively in 1981 through 1984. This leaves an immense production shortfall for the next six years.

Tax benefits are a crucial way of encouraging invesment to meet this production shortfall. A reduction of these benefits would increase the cost of rental housing, and have an adverse effect upon the provision of affordable rental housing, especially for low and moderate income families.

The need for rental housing arises from several factors. First, the increased cost of purchasing a home, as interest rates have spiralled upwards, has forced many families to remain in the rental market. Higher demand has increased rents, making it more difficult for even moderate income families to find decent affordable housing. While there is a need for low and moderate income housing, the investment economices, without tax benefits and in many cases other assistance, make it uneconomical to build, acquire, or rehabilitate for this market. The median income renter household is $11,400 per year. This translates into $285 in gross monthly income which would be available for rent, assuming a family can set aside 30 percent of income for housing. Interest rates and construction costs make it virtually impossible to produce new rental units that are financially feasible, without substantial tax and other incentives.

Second, housing supply varies from region to region. Some sunbelt areas have an overbuilt situation resulting in high vacancy rates. This obscures what continues to be a severe problem of rental housing availability throughout the rest of the nation. In Boston, for example, the apartment housing stock has declined by 18,000 units over the past 20 years.

Third, many older units are not being replaced. This is particularly the case in situations where rent control exists. According to the 1981 annual housing survey, almost 40 percent of the rental housing stock was built prior to 1939.

These considerations make continuation of tax incentives for rental housing essential.

Congress in 1981 recognized that incentives for investment in real estate, including housing, were an important component of its overall tax reductions and capital formation proposals. This policy should not be changed three years after it was initiated. The Department of Housing and Urban Development (HUD) recognizes the importance of these tax incentives. A HUD study states:

"The 1969 and 1976 rental housing tax provisions reduced the rate of return to rental housing investment and were probably at least partially responsible for a flow of capital investment away from the rental housing sector. The rental housing tax provisions of ERTA have increased the rates of return to rental housing investment."

* * * * * * *

"It is likely that most of the benefits to owners and investors under ERTA will accrue to tenants in the form of lower rental than would be the case without ERTA." (Federal Tax Incentives and Rental Housing, HUD December 1982)

II. The Deficit and Tax Revenues

It is absolutely essential that Congress and the Administration act now in a bipartisan manner to reduce the federal deficit. Otherwise, we will be heading into a recession in 1985 and 1986. Certainly, that would not be the time to raise taxes or cut spending.

NAHB urges Congress to go beyond consideration of a small down payment on deficit reduction. NAHB recommends that the FY'85 Administration $925 billion budget be reduced by 10 percent or $92.5 billion in FY'85, through a combination of spending cuts and revenue increases, if necessary. Tax increases should focus upon an across-the-board approach instead of relying solely on closing so-called "loopholes."

Otherwise, the economy may not be able to sustain the growth necessary to continue to finance the government. Deficits in the out-years could exceed $300 billion, according to the latest CBO baseline projections. Despite the generally optimistic figures on housing starts and unemployment, the underlying health of the economy remains fragile. NAHB's housing affordability index, of which interest rates are a major factor, has shown a downward trend, evidence that potential home buyers are now being priced out of the housing market. A delay until 1985 postpones resolution of the problem until mid-1985 at the earliest. This would push collection of any new taxes and spending restraints into 1986. Such a delay could very well be too late and will continue to perpetuate uncertainty during the period of the delay. The time bomb is indeed ticking, and the clock is approaching midnight.

III. Administration Budget Proposals

NAHB is concerned that the focus for revenue raising is falling most heavily on the real estate industry.

The Committee should realize the partnership mechanism is a major means of raising investment capital for real estate ventures, including rental housing. Real estate does not have the advantage of the investment credit which is often utilized by corporations.

NAHB is pleased that the proposals which the Administration has outlined in its 1985 budget are significantly less far-reaching than those which were originally put forth in 1983 in the Senate Finance Committee. NAHB is studying the proposals and awaits further technical explanation. However, NAHB's preliminary assessment is that the measures are directed primarily towards reducing tax shelter transactions which push the limits of legality.

NAHB wants to work with this Committee in curtailing truly abusive situations which have no relationship to economic reality and business practice. Detailed technical comments, which NAHB has developed with other members of the real estate community, are included as Appendix II to this testimony.

While most of the proposals can be made to work with technical refinements, NAHB is deeply concerned about the Treasury recommendations dealing with deferred payments and premature accruals. What often happens in real estate transactions is that sellers will finance the sale of the property with a purchase money note. A portion of the interest owed to the seller may be deferred. The purpose to permit adequate cash flow and provide the purchaser with funds from cash flow to maintain and improve the property. In transfers of HUD properties this is the case and is in fact, manditory under HUD regulations.

It is a general principle of taxation that income is not taxed until it is actually received. Otherwise taxpayers are forced to pay tax without adequate cash to do so. This is the case and is in fact, manditory under HUD regulations.

It is a general principle of taxation that income is not taxed until it is actually received. Otherwise taxpayers are forced to pay tax without adequate cash to do so. This is the result of the Treasury's deferred payment accrual proposals, which would apply the original discount rules (OID). The proposals require the reporting of income as the interest accrues, regardless of whether it is paid. The Treasury recognizes the inherent unfairness of the idea by exempting individual home sales and family farms.

NAHB urges the Committee to modify substantially or reject these aspects of the Treasury proposals. Additional comments on this and other provisions of the Treasury recommendations and the Dole proposals are contained in Appendix II of this testimony.

The Committee should also recognize that many transactions have been structured under the current rules and were negotiated with these rules in mind. Appropriate transition rules and effective dates should be clearly set forth as the Committee acts.

The proposals should contain effective dates no earlier than the date of enactment in order to be fair to all taxpayers and to give taxpayers time to modify pending business transactions. The proposals should also contain "grandfather" clauses to protect transactions entered into pursuant to contracts which are binding on the taxpayer on the effective date and transactions pursuant to which properties have been acquired or construction or rehabilitation begun. A small number of transactions will inevitably be entered into shortly before the effective date, but the problems of curtailing existing legitimate business activity by imposing a retroactive effective date are far greater.

IV. Conclusion

In conclusion, NAHB urges you to look closely at the implications of the Administration's "tax shelter" proposals.

While many of the changes are complex and highly technical, each has an effect upon real estate and real estate investment. The Committee should refrain from an extreme position and seek to curb practices which are clearly abusive. The partnership allocation provisions should not be revised as suggested in the Democratic Study Group Amendment.

NAHB looks forward to working with this Committee and its staff in developing legislation which will promote efficiency and fairness in the tax code while preserving essential incentives for housing.

I would be pleased to answer any questions that you may have.

APPENDIX I

NAHB RESOLUTION

Title: Tax Shelter/Special Partnership Allocations.
Original Sponsor: Special Committee on Taxation.

Whereas, the limited partnership is a major vehicle for attracting capital investment in real estate, especially low income housing; and

Whereas, limited partnerships provide flexibility in structuring transactions to meet the special needs of each particular situation; and

Whereas, special allocation of items of income, loss, credit, and deduction are essential elements of the limited partnership; and

Whereas, other investment incentives are also provided for investment through limited partnerships under current tax rules; and

Whereas, Congress may consider eliminating these incentives, which would make real estate investment less competitive than other types of investment,

Now, therefore, be it *Resolved* that the National Association of Home Builders supports current rules governing special allocation for limited partnerships and other essential incentive to encourage capital investmeft in real estate and housing.

Board of Directors Action: Recommends Approval.

Joint Executive/Resolutions Committee Action: Recommends Approval.

Resolutions Committee Action: Recommends Approval.

Special Committee on Taxation Action: Recommends Approval.

APPENDIX II

February 24, 1984

COMMENTS ON THE PROPOSED CHANGES IN THE TAX LAW REGARDING PARTNERSHIPS AND ACCOUNTING RULES

These comments are addressed primarily to the proposals relating to the tax shelter and "accounting reform" provisions contained in the Fiscal Year 1985 Budget submitted by the Administration to Congress on February 1, 1984 (the "Administration proposals") and similar proposals circulated by Senator Dole on November 16, 1983 (the "Dole proposals"). The comments also address certain other proposals such as the extension of real property recovery periods that would have drastic adverse effects on the formation of capital for many types of business and industrial ventures. No legislative language was available at the time these comments were prepared but they reflect the general understanding of the proposals.

The comments that follow discuss the substantive impact of the proposals in detail. However, the date on which the proposals become effective is no less important than their substance. The real estate industry strongly urge that effective dates be selected that are no earlier than the date of enactment in order to be fair to all taxpayers and to give taxpayers time to modify pending business transactions. The proposals should also contain "grandfather" clauses to protect transactions entered into pursuant to contracts which are binding on the taxpayer on the effective date and transactions pursuant to which properties have been acquired or construction, reconstruction or rehabilitation begun. A small number of transactions will inevitably be entered into shortly before the effective date, but the problems of curtailing existing legitimate business activity by imposing retroactive effective dates are far greater.

1. Real property cost recovery periods

The most damaging proposal that has been circulated would extend the real property cost recovery period from 15 to 20 years. This would shift much investment capital away from real estate and would result in a substantial curtailment of new and renovated housing and commercial properties across the nation. Reductions in interest rates and a high level of pent-up demand has permitted real estate to attract capital during the past two years. However, these favorable circumstances should not obscure the substantial body of evidence that any increase in the real property recovery period will put real estate investment at a disadvantage in comparison with investment in equipment and other personal property. The Congress clearly recognized this disparity in investment incentives in 1981 when it selected the 15-year recovery period and it should not reverse that decision.

It has been also suggested that the recovery period be extended only for used structures. This proposal would not only compound the problems between real estate and other investments but would create additional distortions among real property investment decisions. The impact would be particularly harsh on rental and low-income housing as well as small businesses since it would reduce the value of property currently held. With respect to low income housing, it would substantially reduce the incentive to invest new capital in order to rehabilitate, modernize, and in some instances prevent default of older government-assisted housing.

2. Partnership allocations and distributions

a. Administration proposal

If a direct payment by the partnership for property or services would be chargeable to capital, distributions to a partner for such property or services would be treated the same as those made in a transaction between the partnership and one who is not a partner. Thus, those amounts would have to be capitalized. In addition, certain arrangements whereby a partner contributes property to a partnership and receives a contemporaneous distribution will be treated as a sale among partners or as a part sale/part contribution to the partnership.

b. Dole proposal

Special allocations of separate items of partnership income, gain, loss, deduction, or credit would no longer be permitted. Only "bottom line" allocations would be permitted.

c. Comments

We agree that abuses may occur when partnerships are structured so that payments which should be capitalized are disguised in order to be deducted as an allocation of income. So long as the definition of items which must be capitalized follows current law regarding guaranteed payment, we believe the Administration proposal is a reasonable solution to this potential abuse. We oppose, however, the Dole proposal regarding item allocations because it is overly broad and places unnecessary and unreasonable burdens on legitimate business arrangements.

3. Retroactive allocations

a. Administration proposal

Retroactive allocations of partnership taxable income and loss would be prevented in the case of a cash basis partnership and a tiered arrangement.

b. Dole proposal

All allocations would have to be done on a daily basis for the year in which partners were admitted.

c. Comments

Both proposals would attack a customary and legitimate business practice by denying to partners deductions for expenses which may have been paid with funds they contributed to a partnership, if the obligation to pay those expenses was incurred prior to the partners' date of entry. Investor limited partners are normally brought into a partnership for the development of real estate over a period of time within which the partnership is moving forward on various elements of its business. Obligations are undertaken during this period in the expectation that investor limited partners will provide the funds with which to meet those obligations. There is no justification for denying cash basis taxpayers the right to deduct expenses paid after their entry to the partnership, particularly when the economic structure of the partnership anticipated paying those expenses out of new investor funds.

In addition, the specific proposal for computing allocations on a daily basis or on a strict prospective basis from the day a partner enters a partnership would place an unjustifiable administrative burden on the partnership. Many items, such as rental receipts, interest charges, ACRS depreciation under Code § 168 and the amortization of certain expenses relating to the beginning of a partnerships's or corporation's business or acquisition of assets, use monthly accounting periods. Thus, partnership accounting and management information systems could accommodate a change in the law which permitted the partnerships to allocate to partners admitted to the partnership in a particular month only those expenses and other items attributable to the month. Although such a change in the law would be unjustified and inappropriate, it would at least be technically workable.

4. Property contributed to a partnership

a. Administration proposal

The rules relating to the allocation of depreciation, depletion, gains and losses on contributed property would be changed. Under these rules, any built-in gain or loss from a sale of the property would have to be allocated to the contributing partner. Depreciation and depletion would be allocated to the contributing partner and the other partners in proportion to their interests in the partnership. Thus, the elective rule in present law to allocate gain or loss and depreciation and depletion so as to take account of precontribution appreciation or depreciation in the property would be made mandatory, with certain minor modifications.

Built-in losses on contributed capital assets would retain their character as capital losses for five years. Property that was inventory in the hands of a contributing taxpayer would retain its character as ordinary income property for five years in the hands of the partnership. Gain from unrealized receivables contributed by a partner would constitute ordinary income to the partnership.

b. Dole proposal

The Dole proposal is the same as the administration proposal but does not appear to differentiate between the "built-in" gain or loss as of the date of the contribution and the future appreciation or depreciation, if any, in the contributed property's value.

c. Comments

Use of the partnership structure should not permit taxpayers to escape "dealer" status or change the tax treatment of a particular piece of property, and the gain or loss attributable thereto, simply by making a contribution of the property to a partnership. However, this can be accomplished in a more equitable manner than either the Administration or Dole proposals.

In accordance with the Administration proposal, "built-in" gains or losses on contributed capital assets should be allocated to the contributing partner and should retain their character in that partner's hands for five years. Further, gains or losses attributable to that property in the five years subsequent to contribution should be treated for tax purposes—with respect to the contributing partner—as if the contriubtion had not taken place. For the remaining partners, however, the tax treatment of the property should be the same as any other property of the partnership. Under this structure, the contributing partner cannot reap any tax benefit by virtue of having contributed the property to the partnership, but the partnership is not unfairly penalized simply because of the prepartnership tax status of a particular piece of property contributed to it.

5. Like-kind exchanges of partnership interests

a. Administration proposal

Tax-free, like-kind exchange treatment would be unavailable for exchanges of partnership interests in different partnerships. Also, gain would be recognized generally on like-kind exchanges that were not completed within 90 days after the property transferred is relinquished.

b. Dole proposal

The Dole proposal is similar to the Administration proposals except that exchanges must be completed within three months after the taxable year in which the first transfer occurred and the property received must have been designated at the time of the transaction.

c. Comments

The basic thrust of this proposal is—or should be—to eliminate the tax-free exchange of limited partnership interests. The proposal, however, goes well beyond this objective to preclude the exchange of general partnership interests on a tax free basis. Recent court decisions such as Gulfstream Land and Development Corporation, 71 T.C. 580 (1979), have held that general partnership interests are sufficiently distinguishable from stocks, choses in action, etc., to be excluded from the parenthetical language under Section 1031 and should, therefore, be entitled to non-recognition treatment under certain circumstances. These holdings stand for the proposition that non-recognition treatment should be available, at least where the holder of the partnership interest is actively engaged in the partnership business as a general partner and the underlying assets of the partnership would qualify for Section 1031 treatment.

It may also be necessary for business reasons for partners to rearrange their holdings of partnership interests and/or diversify their partnership interests due to circumstances that are clearly recognized in the non-taxable corporation reorganization provisions. In these circumstances, it is understood and agreed that partnership liabilities should be considered and boot computed as if the assets and liabilities were exchanged directly. Thus, partners would, after liquidating their partnership interests, be able to qualify for Section 1031 treatment (see Magneson, 81 T.C. 47). To exclude these interests from qualifying under Section 1031 would be inequitable and inconsistent with the overall thrust of the statute.

In addition, the requirement for specific and immediate identification of the qualifying property contained in the Dole proposal will cause serious problems in many real estate transactions. For example, the taxpayer may have every intention to use the designated property, but what happens if the negotiations fall through? How are substitutions of property treated if the requirement for a substitution is beyond the taxpayer's control? To avoid these problems, the proposal should be modified so that the property for which the exchange is to be made must be specifically designated within one year after the close of the taxable year.

With respect to deferred, non-simultaneous exchanges, the five years allowed under *Starker* v. *U.S.*, 602 F.2d 1341 (9th Cir. 1979) is too long, but the three month period contained in the Administration proposal generally will be inadequate to negotiate and close a real estate transaction. The Dole proposal should be modified to permit exchanges up to one year after the close of the taxable year.

6. Deferred payments

a. Administration proposal

Section 483 would be revised so that interest rates would differ depending on the maturity of the obligation and be adjusted every six months. Further, the safe-harbor interest computations would be made on a compound interest basis. The proposal also provides that imputed interest would be taken into account under the periodic inclusion rules of section 1232A (and the corresponding rule for deductions in sec. 163(e)). The maximum test rate for real estate transactions between related parties under present law would be retained. The exception to section 483 for sales of ordinary income property would be repealed. The capital asset limitation and the natural person exceptions to section 1232A would be repealed.

The scope of the original issue discount (OID) rules would be expanded to include the purchase or use of property or services for discount obligations where neither the property or services nor the obligations are publicly traded. This means that the seller of property on the installment basis would have to report as taxable income all interest accrued on the installment obligation (whether or not received), even if he is a cash basis taxpayer. In these cases, the amount of the interest which is deemed to accrue would be determined by reference to the interest rates under section 483. Exceptions to the expanded OID rules would be provided for transactions such as sales of farms by individuals or closely held businesses, sales of principal residences, and sales involving payments of $250,000 or less. For these excepted transactions, deductions for discount interest would not be allowed and discount income would not be recognized prior to the time of payment.

b. Dole proposal

The original issue discount rules would be extended to apply to sales of nonmarketable property, and in tax shelter contexts, to deferred payments for services and use of property, in each case subject to the appropriate de minimis rule. Individuals would be excepted from the expanded original issue discount rules. In addition, imputed interest would be calculated on the basis of a compound interest rate (instead of simple interest), and allocated among deferred payments on an economic basis. With respect to deferred payment sales of property, anti-abuse provisions would prevent avoidance of the original issue discount rules and claims of inflated depreciation and investment tax credits.

c. Comments

These proposals would have a severe and adverse effect on the sale and preservation of real property generally, and have a particularly drastic impact on low-income housing. First, the proposals would require a cash basis seller to be taxed on "phantom" or imputed income which the seller would not acutally receive until years in the future. Thus, sellers would be penalized for financing a sale of their property. For example, in transfers of government-assisted housing, where cash flow is restricted and interest must be accrued rather than paid, sellers would not be able to receive enough cash to pay the taxes owing to their phantom income. As a result, the buyers of such housing would have a drastically reduced basis and no incentive to contribute the additional capital needed to maintain and preserve the building properly. In addition to the low-income housing problems, economically troubled businesses might be prohibited under these provisions from negotiating the deferral of payments to creditors and suppliers who would be willing to assist such businesses in surviving periods of recession. Finally, this rule would arbitrarily force the cash taxpayer to be taxed on an accrual basis.

The second problem under the rule is the requirement that imputed interest be calculated on a compound basis rather than as simple interest. This proposal runs contrary to historic and customary practices in the U.S. real estate industry, as well as many state laws which required real estate interest calculations to be made on a basis of simple interest.

It is appropriate for the Congress and the Administration to be concerned about abusive transactions in which interest is accrued that will never be paid and values are inflated artificially. However, abuses of this nature can and have been dealt with under the recently enhanced IRS enforcement and penalty procedures. If further action is necessary, the proposed rules should only be enacted if they include (1) a safe harbor which would apply if the purchaser of an obligation on an installment basis paid at least 50 percent of a market rate of interest on an annual basis and accrued the balance and (2) low-income housing transfers were exempted. This exemption is necessary because the cash flow with which to pay any portion of additional interest resulting from a second mortgage is not available.

7. Premature accrual

a. Administration proposal

The "all events" test would be clarified to provide that no deduction would be allowed until economic performance occurs. For example, a deduction would be permitted when services are performed, when use of property occurs and, in the case of workmen's compensation or similar liability, when the liability is satisfied. An exception to this rule would be provided for cases in which economic performance will occur within one year after the end of the taxpayer's taxable year. Exceptions to this rule would be made for transactions to which other sections apply, for example, for the deduction allowable under section 166 (relating to bad debts). Also, the net operating loss carryback rules would be amended to allow losses to be carried back to the year in which the obligation generating the loss arose.

b. Dole proposal

A deduction would not be allowed for the full face amount of any item that is payable more than one year after the taxable year. The taxpayer would have to choose between deducting currently the discounted present value of the amount or taking the full amount of the deduction when the liability is actually paid. The discount rate would be an after-tax discount rate computed with reference to the rate applicable for interest on tax deficiencies and refunds (i.e., 54 percent of the sec. 6621 interest rate). An adjustment would be required if the amount is paid substantially before or after the time at which it was estimated it would be paid.

c. Comments

The Administration proposal would only restrict deductions where "economic performance" has not occurred. In this context, the performance of services and the forebearance of money owed should be considered "economic performance." Thus, payment may be accrued so long as the goods or services for which the payment was owed have been received or performed. This is a reasonable approach, but the Dole proposal goes much too far in denying the accrual of legitimate obligations.

8. Prepayments of expenses

a. Administration proposal

The deduction of prepaid expenses prior to the period to which the expenses are allocable would be prohibited to "syndicates" other than farming. The prohibition would apply to both cash and accrual taxpayers.

b. Dole proposal

Cash basis taxpayers would be prohibited from deducting expenses for goods or services which are not received within three months after the close of the taxable year.

c. Comments

The prepayment of expenses has the potential for abuse. We would point out, however, that there are many instances where legitimate and customary business practices prepay expenses for non-tax related reasons. For example, most forms of insurance and many real estate taxes are paid once a year and in advance. Similarly, taxpayers may prepay expenses to simplify billing, bookkeeping, and other associated administrative costs for the payee as well as the taxpayer. Under current case law, as set forth in *Zaninovich* v. *Commissioner,* 16 F.2d 429 (9th Cir. 1950), prepayments of expenses for up to one year after the date of payment are currently deductible. We believe this is a reasonable and appropriate standard which eliminates the potential abuse of prepaying expenses many years in advance, but it does not impose costly and burdensome requirements on legitimate business transactions.

9. Related party transactions

a. Administration proposal

Taxpayers subject to this provision would be required to defer deductions for accrued interest and expenses owed to a "related" taxpayer until actually paid. The definition of "related" parties would be expanded to include partners, partnerships and controlled corporations regardless of the amount of common ownership interest.

b. Dole proposal

The proposal is similar to the Administration proposal except that the provision would not apply if the common ownership interest in both parties was five percent or less.

c. Comments

It is essential that some form of a *de minimis* exception be provided for common partnership interests. We propose a minimum ten percent ownership in capital or profits. This minimum amount tracks the percentage used in the "anti-churning" provisions of section 168(e)(4) of the Internal Revenue Code for related parties. The ten percent minimum also reduces the possibility that parties will become "related" inadvertently as, for example, through the purchase by one person of investment units in a new partnership which is the owner of property in which the person has, or even formerly had, an interest.

Moreover, in situations involving transfers of government assisted housing, old partnerships or persons owning the property and new partnerships purchasing the property will often be related for such non-tax reasons as the governmental regulatory agency preference for continuity of management. In addition, agency rules normally prohibit the new partnership from paying some or all of the interest on the purchase money notes currently, because HUD rent restrictions do not permit enough cash flow to pay the interest on a current basis. Enforcement of the proposals would contradict HUD support for transfers which allow deteriorating projects to be refurbished in order to avoid costly government foreclosures.

Mr. PEASE [presiding]. Thank you very much, sir. We appreciate your testimony.

Next we will hear from the National Realty Committee, Mr. Aronsohn.

STATEMENT OF ALAN J. B. ARONSOHN, TAX COUNSEL, NATIONAL REALTY COMMITTEE

Mr. ARONSOHN. Thank you.

My name is Alan Aronsohn. I am a member of the New York City law firm of Robinson, Silverman, Pearce, Aronsohn, & Berman, and I appear here today on behalf of the National Realty Committee. The National Realty Committee generally supports the administration's goals reflected in their proposals dealing with tax shelter abuses generally, and partnership and corporate tax reform.

However, we have some serious reservations about the effectuation of such goals. We have dealt with about 15 specific proposals in our written statement which I hope that members of the committee will read, and I will limit myself to a few oral observations.

Taking, for example, the partnership proposals as a group, in our view, these proposals generally deal with far less serious alleged abuses than some other areas, but they inevitably introduce considerable increased complexity in the code.

We would like to ask the committee to remember that not every partnership is a tax shelter partnership, and that there is a social cost in diminishing business flexibility and increasing tax complexity.

For example, we think that the proposal to require mandatory application of the so-called aggregate theory to every contribution of property to a partnership is theoretically impeccable, but as a practical matter would require every property contribution to a partnership, if the proposal is enacted, to be valued at fair market value. This would impose a burden you do not have under present law, and a burden that we do not think is required to take care of whatever abuses there are in this area, which in our view are minimal.

With respect to the provisions dealing with accounting and time value of money, we recognize that these problems are far more serious. However, for the reasons given by other speakers, we feel that the complexities in the current proposals require a considerable amount of study, and that those proposals, to become workable, would probably require some amelioration of their more extreme applications.

We also believe that with respect to the related party rule extension, that if there are going to be changes in the original issue discount provisions and the imputed interest provisions as suggested, that the main purpose for the related party proposals disappears, and that we do not really need proposals in the related party area that are anywhere near as onerous as the ones that have been proposed.

Specifically, we think that where a partnership relationship exists, there should be some de minimis exception to applying the related party limitations to such a transaction. Currently the proposal would apply these limitations whenever there was any relationship whatsoever. Finally, with respect to that proposal, we think that if it is enacted, it should be effective with respect to transactions occurring after the date of enactment and not retroactively.

The last point that I would like to mention is a proposal which is not dealt with in our written statement, because it was made very recently in the Senate Finance Committee, but it obviously is going to become an issue. This is the proposal to change the ACRS recovery period for used real property from 15 years to 20 years. Beyond the issue of simply picking out one kind of property and changing the ball game with respect to that narrow area, a recent study submitted to a Brookings Institute economic panel indicated that even a 15-year recovery period for real property results in a distortion of corporate investment from structures into personal property because of the disproportionate tax benefit that personal property enjoys through the investment tax credit and the 5-year ACRS life.

If you stretch real estate recovery periods to 20 years, you exacerbate that further.

Finally, I would urge you to consider very carefully whether or not you want to reintroduce any distinction between new and used property. One of the few simplifications that we have had in recent years was the elimination through the ACRS system of the prior law distinctions between depreciation available to new property versus used property, with the concommitant necessity to determine when a structure was first placed in service, which at times is a very difficult issue.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF ALAN J. B. ARONSOHN, TAX COUNSEL, NATIONAL REALTY COMMITTEE

This statement on legislative proposals affecting tax shelters, tax accounting rules and corporate taxation is submitted on behalf of the National Realty Committee ("NRC"). The NRC is a nonprofit business league whose membership includes owners, operators and developers of all types of real estate throughout the United States.

The NRC generally agrees with the goals and recommendations of the Administration contained in its fiscal year 1985 budget to deal with abusive shelters, uneconomic accounting methods and certain corporate tax problems. However, the NRC is concerned about policy implications inherent in a number of proposals (including some proposals which the NRC does not oppose) and disagrees with certain proposals, or aspects thereof, explained in more detail, below.

The NRC's final position with respect to these proposals, including those with which it agrees, can only be formulated following an analysis of the extent to which the forthcoming statutory language achieves the Administration's announced goals without creating unintended, adverse effects.

1. TAX SHELTER PROPOSALS

The proposals dealing with retroactive allocations, limitation on partnership allocations and recharacterization of certain partnership distributions, contributions of property to a partnership and like-kind exchanges raise a number of questions.

Retroactive allocations

Retroactive allocations of partnership items are barred generally under present law. Attempts to circumvent this prohibition, for example, with two-tiered partnership structures, should be prohibited, as the Administration suggests. However, it does not seem necessary to alter radically the cash basis accounting rules, as the Administration proposes, to prevent such abusive allocations. Present law permits a cash basis partnership to use an interim closing of its books to allocate items before and after the entry of a new partner. The NRC questions whether this rule has permitted substantial abuse and whether its repeal presents any significant opportunity for revenue gain. It is clear that mandating proration over the entire taxable year, in lieu of permitting an interim closing of the partnership's books, may produce some strange results.

Suppose, for example, A and B form a nontax shelter partnership which engages in a business, adopts a calendar year and employs cash-basis accounting. The AB partnership currently is sustaining out-of-pocket losses in its business at the rate of $100 per month and owes $1,100 for deductible expenses by the end of November 1984. If the partnership were to admit new partner C as a third partner for a contribution of $1,100 that is used to pay the accrued expenses, proration of the total loss for the year among all three partners results in the allocation of the bulk of the loss to A and B, a somewhat strange result under the circumstances. Current law, by permitting an interim closing of the partnership's books, without changing the partnership's cash basis accounting method, permits allocation of at least a third of the loss to C, the partner actually sustaining the expense.

Additional problems may result from the proposal to allocate unpaid expenses to the protions of the taxable year in which they were "incurred." Again, assume the A B partnership described above "incurs" an annual insurance premium in January and C is admitted in February. Allocation of the entire deduction for the premium to A and B appears to be a questionalbe result.

Nevertheless, if the Congress determines that it is necessary to require cash-basis partnerships to allocate incurred but unpaid expenses among partners on an accrual basis, the NRC does not oppose the enactment of reasonable rules to achieve this result. Such rules should include reasonable allocation periods. Daily allocation of partnership items would create expensive accounting burdens disproportionate to any prevented abuses. Since many business and tax matters (for example, rents, utility charges, ACRS deductions) already must be accounted for on a monthly basis, the NRC suggests tax allocations on a monthly basis as well.

Limitation on partnership allocations and recharacterization of certain partnership distributions

The proposal to disregard "any allocation of income" under a partnership agreement if the allocation is "made in respect of, and in connection with," a distribution to a partner who has contributed certain property or services to the partnership appears overly broad. It is difficult to analyze the proposal thoroughly in the absence of statutory language, particularly since its description in the Administration's General Explanation of the revenue proposals is unspecific and vague.

The NRC would agree that in many cases a purported allocation of "gross income" should appropriately be treated as a guaranteed payment under Code section 707(c) or as a payment to a partner not acting in his capacity as a partner under Code section 707(a). However, the NRC opposes any change in the traditional treatment of so-called "moneyman-expert" partnerships in which capital is supplied by one partner and services supplied by another partner with a sharing of future partnership net income. In such a situation, attempting to impute a capitalizable fee to the service partner would open up a Pandadora's box of controversies between taxpayers and the Service as to both the nature of services being performed and the appropriate imputable fee therefor.

Furthermore, the performance of services by a partner in his capacity as a partner for the partnership of which he is a member is more appropriately compared with the performance of services for oneself than for a separate taxable entity. An architect building a house for sale does not realize income reflecting the imputed value of his plans. Similarly, if the architect provides plans for a partnership in which he has an interest in future net profits, the architect should not realize income nor should the partnership claim any deduction (in the absence of a specific payment by the partnership to the architect for such work) with respect to such plans.

Changing these traditional relationships in the partnership area would have sweeping consequences for many business activities. Such changes should certainly not be undertaken without considerable study and debate.

The second part of the proposal dealing with contribution/distribution arrangements is also difficult to analyze appropriately in the absence of statutory language. Despite the Administration's concern with the results reflected in a number of litigated cases involving contribution/distribution situations, the Treasury Regulations have always provided that contributions of property to a partnership coupled with distributions of cash or other property may be treated as sales or exchanges. Treas. Regs. Secs. 1.721-1(a) and 1.731-1(c)(3). The issues involved in the situations giving rise to the proposals are essentially factual. It is difficult to see how the introduction of additional ambiguous statutory language will increase the efficiency and administrability of the income tax law in this area. Statutory changes are warranted only where they are a demonstrably clear improvement over existing law. In the NRC's view, the Administration's proposals relating to limitations on partnership allocations and recharacterization of distributions do not satisfy that burden.

Property contributed to a partnership

The NRC has similar concerns about complexity with respect to the proposal to impose a mandatory, aggregate-theory rule to contributed property transactions with partnerships. While theoretically unimpeachable, requiring all partnerships to allocate precontribution appreciation to the contributing partner will often create accounting problems disproportionate to any potential abuse. NRC is not aware of the existence of any large-scale abuse arising from the flexibility permitted with respect to precontribution appreciation under current law. The present application of the entity theory to property contributions (in the absence of taxpayer election to the contrary) obviates the necessity of determining the fair market value of contributed property at the time of contribution. Obviously, this entity theory rule allows much greater administrative simplicity for both taxpayers and the Government in most cases.

The NRC does not oppose the proposal for a carryover of the character of contributed property from the contributing partner to the partnership. The NRC believes that present law prohibits transactions expressly designed to create wholesale shifts of gains or losses with respect to a particular property contributed by one partner to or among other partners, along the line suggested in the Administration Explanation. To the extent that such transactions actually occur, they are subject to attack in most cases as sham transactions lacking any non-tax business purpose. The NRC suggests that such situations are more appropriately dealt with by the courts than by fruitless attempts to create a perfect world through legislation.

Like-kind exchanges

The NRC believes that the most serious potential abuses of the tax-free treatment afforded like-kind exchanges by section 1031 have been eliminated by the application of the section 453 installment sales rules to such exchanges. In particular, the 1983 amendment of section 453(f)(6) appears to require tranferors to recognize as a payment in the year of exchange any gain with respect to liabilities which exceed the basis of the transferred property and which are assumed by the transferee. Moreover, the proposed expansion of the original issue discount (OID) rules should further reduce abusive tax schemes in this area. In view of the broader application of the installment sales OID rules, abusive situations appear minimized. Treating like-kind exchanges as a form of installment sale should entail no additional administrative burdens for the IRS or for taxpayers. Only in very rare circumstances will amended returns ever be required.

If the Congress nevertheless decides to limit the time period for completing like-kind exchanges, the NRC urges that it allow taxpayers a period no less than the shorter of one year or the next tax return due date.

The NRC sees no policy reason for barring like-kind exchanges of partnership interests. If individual taxpayers are allowed to make tax-free property exchanges in their individual capacities, they should not be barred from such exchanges as partners. Exchanges of partnership interests are not comparable to stock and securities swaps. Unlike stocks or securities, few partnerships are widely-held or publicly-traded and therefore have no readily determinable fair market value.

In addition, it is often difficult to distinguish exchanges of partnership interests from asset exchanges which follow liquidations of partnerships. The NRC believes that taxpayers should be permitted to exchange like-kind property under Code section 1031 where such property was received in a distribution from a partnership, even though the property received in exchange is contributed to a partnership subsequent to the exchange. Since it is often difficult, where real estate is involved, to distinguish the technical existance of a partnership for tax purposes, as opposed to a tenancy-in-common, treating exchanges of partnership interests as in effect exchanges of the underlying assets would elimiante characterization problems which otherwise inevitably arise.

2. ACCOUNTING PROPOSALS

The NRC also is concerned with the proposals dealing with deferred payments, related-party transactions and prepayments of expenses.

Deferred payments

Application of the OID provisions to discount obligations for property and services will be complicated even for sophisticated and well-advised taxpayers, partciularly in transactions involving contingent prices and variable payment dates. The conjuction of rules for imputed interest and original issue discount requires detailed clarification. Requiring symetrical inclusion and deduction of interest computed on an OID basis will be more difficult in situations, not uncommon in the real estate industry, where the interest-payor is not the original issuer of an obligation. Economic hardship may result where the current payment of interest (or other items) is restricted by statute or regulations.

Related-party transactions

The NRC urges the Congress to consider whether the proposal to require matching of deductions and income recognition on transactions involving related parties is necessary if the proposals to expand the OID rules are adopted. The latter proposals may be adequate in themselves to prevent most of the revenue loss attributable to mismatching under current law.

If the Congress decides to impose a separate rule requiring related parties to report transactions consistently, persons whose common ownership in an entity is less than a fixed minimum percentage should be excepted. The NRC recommends a 10-percent floor be provided before a partner is considered related to a partnership or other partners. A floor is necessary to prevent persons, especially third-parties lacking knowledge of or control over others, from becoming inadvertently "related." The present section 267 regulations make a partner of a partnership related to that partnership only to the extent of such partner's interest in the partnership. Treas. Reg. Sec. 1.267(b)-(1)(b). This rule should continue to apply to any partner-partnership transactions not involving a 10-percent or more relationship.

The NRC strongly urges the Congress not to limit any related-party grandfather rule only to transactions subject to binding contracts on September 29, 1983, as the Administration recommends, but to grandfather all transactions subject to binding contracts as of the date of enactment. Unless all such transactions are grandfathered, the related-party rule will impose unreasonable burdens on partnerships and corporations who could not have been aware of any need to monitor transactions in their shares or partnership interests either between or with their shareholders or partners to determine whether any related-party transaction has already occurred requiring the entities and their shareholders or partners to follow special tax accounting rules. If this reform is necessary, equity demands grandfathering all transactions entered into prior to the date of enactment.

Prepayments of expenses

Although the Administration would limit application of its proposal on prepayments of expenses to tax shelters, the NRC is concerned that legitimate business enterprises may be affected, particularly in loss years, because the definition of a tax shelter will be unclear and subject to varied interpretations.

Clearly, abusive prepayments of expenses should not be recognized for tax purposes. However, payments of expenses for a year or less in advance should not be regarded as abusive, at least where annual advance payment is a customary practice, for example, in the case of certain tax or insurance charges.

3. CORPORATE TAX CHANGES

The NRC is concerned about the proposals dealing with leveraged stock investments and collapsible corporations.

Debt-financed portfolio stock

Disallowing interest deductions with respect to leveraged purchases of any stock by a corporation seems an unusually broad attack on a problem which, albeit legitimate, can be solved with a less sweeping rule. Interest paid or incurred to purchase or carry corporate stock is not directly comparable to interest paid or incurred to purchase tax-exempt bonds. Unlike tax-exempt interest, stock dividends are excluded by their corporate recipients pursuant to the dividends received deduction only after having been taxed previously at corporate rates when realized as earnings by the distributing corporation. The dividends received deduction simply reduces the aggregate number of corporate level taxes on the transmission of corporate earnings to the ultimate non-corporate shareholders.

For many real estate businesses which frequently operate through multiple, leveraged corporate structures, disallowance of their interest deductions with respect to corporate businesses and investments would force them to pay corporate taxes several times on the same income or to forego traditional structural and financial arrangements. If the Congress decides that additional statutory authority is necessary to end abusive, leveraged stock purchases, the NRC would narrow the proposed rule and would apply the interst deduction disallowance only in the case of leveraged purchases of stock which is preferred or publicly-traded.

Collapsible corporations

Although not opposed to the expansion of the section 341 collapsible corporation rule, the NRC is concerned about the may complexities which already make section 341 rife with traps for the unwary. Particularly troublesome is the provision's potential for inadvertent conversion of legitimate capital gain into ordinary income. The NRC urges the Congress to help prevent undue and inadvertent application of section 341 by excepting from the application of the collapsible corporation rule gain recognized by taxpayers with respect to transactions for which they have made property elections under section 333 (relating to recognition of gain in certain complete liquidations). The NRC would include in this exception a requirement that inventory property distributed in a section 333 liquidation would retain its character (or "taint") as inventory in the hands of the distributee shareholders.

4. FIRPTA WITHHOLDING

Even though recent revisions of the proposed regulations under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA") are substantially better than earlier drafts, the FIRPTA reporting system remains complex and burdensome and should be repealed. A FIRPTA withholding system, however, will entail many of the same problems as the reporting system while creating additional ones of its own. Of particular concern is the responsibility of the purchaser for determining whether a seller is (or includes) a foreign person. If stringently enforced, the provision will fall harshly on purchasers; if weakly enforced, withholding will be unevenly imposed.

For taxpayers in many areas of the real estate industry, the present reporting requirements and the proposed withholding responsibilities pose difficult legal and practical problems. Many real estate businesses are small operations which lack sophisticated or computerized recordkeeping capacity. They will be unable to identify foreign participation in corporate or partnership sellers. FIRPTA duties, whether reporting or withholding, will cause substantial difficulties for such persons. The NRC considers FIRPTA duties unduly burdensome in comparison with their limited benefit to the revenues and believes the effort to impose such responsibilities should be abandoned.

5. OTHER PROPOSALS

The NRC opposes legislative proposals to extend the at-risk rule to real estate, to repeal the *General Utilities* decision, to eliminate the earnings and profits limitation on dividend treatment for corporate distributions and to tax certain partnerships as corporations.

Extension of at-risk rule

The NRC strongly opposes any extension of the at-risk rule to real estate. Since the enactment of the at-risk rule, the Congress has properly excepted real estate from its application. This treatment recognizes the traditional use of non-recourse financing in real estate transactions and lenders' reliance on the real property involved in a transaction, not the borrower's credit, as the security for a loan.

General utilities

Repealing the *General Utilities* decision in its entirety and requiring recognition of gain (or loss) at the corporate level whenever a corporation makes a distribution of appreciated property to its shareholders, even in liquidating distributions, would constitute a fundamental change in the tax law. Such a change would upset many taxpayers' justifiable reliance on long-settled tax treatment. It would impose an economic hardship on many corporations and their shareholders. Such a significant reversal of longstanding tax policy should be undertaken only after all its potential effects have been identified, evaluated, and, if burdensome, relieved.

Repeal of *General Utilities* and related statutory nonrecognition rules would extend the present burdens of the two-tier corporate-shareholder tax structure to all corporate liquidations and redemptions. The economic problems caused by the failure to integrate our individual and corporate income taxes are likely to be aggravated, unless a repeal of the *General Utilities* decision is accompanied by some form of relief provision to alleviate this double tax burden.

Furthermore, repeal of the nonrecognition rules of *General Utilities* and Code sections 311, 333, 336 and 337, without any accompanying measures to alleviate the impact of such a change, will discourage smaller taxpayers from adopting otherwise appropriate uses of the regular corporate form. Many small taxpayers will be induced to forego the nontax benefits and protections of incorporation in order to escape taxation of the same gain at two levels. As a result, any increased simplicity and certainty achieved by the Subchapter C revision will risk being effectively undone to the extent that taxpayers opt for a single level of partnership taxation despite Subchapter K's complexities and uncertainties.

If the Congress decides to repeal the non-recognition rules of *General Utilities* and the corresponding statutory provisions, the NRC urges that the Congress simultaneously enact relief measures to prevent or reduce potential adverse effects of the change. A shareholder credit for taxes paid on appreciation by a distributing corporation would greatly reduce the immediate adverse impact of the proposed rules in many situations.

E&P limitation on dividends

The NRC opposes proposals to repeal the earnings and profits limitation on the characterization of corporate distributions as dividends. Without this limitation, shareholders may be forced to pay tax on the return of their capital, even in transactions which ultimately result in losses. Assume, for example, that A contributes $100 to the capital of Corporation X, which utilizes the $100 to purchase a 10-year leasehold interest in real property. Assume further that Corporation X receives $20 net rental income from subtenants after the payment of all expenses but before the deduction of any amortization of its cost of acquiring its 10-year leasehold. If the corporation distributes all of its cash flow to A each year, after the payment of corporate tax, it appears unfair to treat the entire cash distribution to A as a dividend despite the fact that $10 a year represents a return of capital.

Some proponents of repealing the E&P limitation have suggested that the adverse consequences of such dividend treatment can be avoided in most cases similar to the above example. They contend that there would be no need to utilize a corporation in the first instance, that any such corporation could be liquidated or, in the alternative they argue that Subchapter S status could be elected.

Unfortunately, there are situations in which non-corporate ownership of property exposes the owners to substantial risks of liability, which they would prefer to avoid by incorporating. In addition, despite the recent liberalization of the Subchapter S rules, Subchapter S treatment is not always available. For example, one non-qualifying shareholder can eliminate the availability of Subchapter S benefits.

Moreover, where the corporate form is used for closely-held businesses, the elimination of the earnings and profits limitation will encourage taxpayers to make their investments with debt rather than equity. This bias in favor of debt will place even greater pressure on the uncertainties that have historically existed with respect to the distinction between corporate debt and equity.

Certain partnerships taxed as corporations

It has been proposed that limited partnerships with publicly-traded partnership interests should be taxed as corporations. Denying partnership tax status to widely-held entities which are generally recognized as partnerships would be a significant departure from the principles of Subchapter K which permits individuals (and other persons) to participate in a common endeavor while maintaining their individual tax (or particular) tax status. Undermining Subchapter K seems an unnecessarily broad approach to solve a problem perceived as a tax-shelter issue. The proposed corporate tax treatment would not be limited to "tax-shelter syndications" (assuming such entities can be accurately identified and statutorily defined), but would apply regardless of the partnership's underlying economic activity. Moreover, the proposal would discriminate against middle-income investors, who lack sufficient capital to participate in privately-placed partnerships available to high-income individuals, and who, as a result of the proposal, would have the return on their smaller investments subject to two levels of taxation instead of receiving Subchapter K's "pass-through" treatment. The NRC strongly opposes this change.

Mr. PEASE. Thank you, Mr. Aronsohn.

Next we will hear from the National Association of Realtors, Peter M. Fass.

STATEMENT OF PETER M. FASS, ESQ., MEMBER, NATIONAL ASSOCIATION OF REALTORS, AFFILIATE, REAL ESTATE SECURITIES AND SYNDICATION INSTITUTE, ACCOMPANIED BY GIL THURM, VICE PRESIDENT AND LEGISLATIVE COUNSEL FOR GOVERNMENT AFFAIRS, NATIONAL ASSOCIATION OF REALTORS

Mr. FASS. I am Peter M. Fass, an attorney specializing in real estate syndications, and I am a member of the National Association of Realtors Real Estate Securities and Syndication Institute. Accompanying me today is Gil Thurm, vice president and legislative counsel for the National Association of Realtors.

Mr. Chairman, it is important for this committee to understand that the National Association of Realtors supports the intent of the Treasury proposals regarding tax shelters and accounting practices. That is, as we have done in the past, we support the identification and limitation of taxation abuses. Our comments will, therefore, be directed to improve those proposals which, although well intentioned, we believe presently go beyond cleansing abusive tax practices, and consequently which we believe may unnecessarily disrupt economically motivated transactions.

As a background, let me comment that 90 percent of the $4.4 billion raised through publicly offered real estate syndications in 1983 did not provide any significant spillover tax losses to limited partners. Only in a few programs which provided equity financing for new construction where no cash distributions could be expected for a year or to by the investors are early tax losses present in a limited amount.

Further, approximately 50 percent of the $4.4 billion raised in 1983, and that is $2.2 billion, were from IRA's and Keoghs and other pension plans, where no tax motivations were present at all.

With your permission, I would like to submit for the record more detailed comments on the proposals before the committee. The balance of my oral statement will focus on what the National Association of Realtors considers to be proposals which require significant attention by Congress to assure the continuation of existing legitimate business transactions.

One item has already been addressed by Mr. Aronsohn, and that is the related party rules. We feel that it is essential that some form of de minimis exception be provided for common partnership interest. We propose a minimum 10 percent ownership of capital and profits which is similar to the percentages in the anti-churning provisions of section 168(e)(4) of the code for related parties.

The 10-percent minimum would reduce the possibility that parties would become related inadvertently, for example, through the purchase of one person of investing units in a new partnership which is the ownership of property in which the person has or even formerly had an interest. If the administration proposal goes forward unchanged, there will be a distinction between corporations where there are de minimis exceptions and partnerships. We suggest a 10-percent test would be fair.

Perhaps the most far-reaching provisions of the administration proposal that would affect the real estate industry are the deferred payment provisions which we refer to as the OID rules. With respect to the sales of real estate, it would mean that a seller who carried back financing would have to report as taxable income all interest accrued on the installment obligations, whether or not received, even if he is a cash basis taxpayer, and this would be done on a compound interest basis rather than simple interest.

The committee should be aware that in several States including New York and Illinois we understand that the compounding of interest on the sales of real property may not be enforceable under law. We note favorably that the administration proposal for the expanded OID rules would exclude certain transactions, including the sales of farms and closely held businesses and the sales of principal residences and sales of real estate up to $250,000.

Unfortunately, we do not think that these exceptions go far enough. The National Association of Realtors supports the deferred payment proposal with respect to the buyer's deduction side of the transaction. However, with respect to the phantom income side, we think that it would interfere with many legitimate real estate transactions where sellers would be required to pay more in tax than they possibly receive on a transaction.

In work out situations or economically troubled transactions, people would be prohibited from negotiating the deferral of payments and accrual of interest because of these rules. Cash flow would seriously be affected.

In summary, we think that the perceived abuse that the administration is addressing by extending the OID rules is to prevent the accrual basis taxpayer purchaser of property or services who makes substantially deferred payments from claiming that overstated deduction. This can be done by applying the OID rules on the buyer side of the transaction. On the seller side, no such distortion exists with respect to the services or the property.

Therefore, we believe that a reasonable compromise would be to extend the OID rules to the purchaser side of the transaction, but allow the seller who is a cash basis recipient not to recognize taxable income on the accrued amounts.

Thank you.

[The prepared statement follows:]

STATEMENT OF PETER M. FASS, ON BEHALF OF THE NATIONAL ASSOCIATION OF REALTORS®

I am Peter M. Fass, I specialize in real estate syndication, and I am a member of the National Association of Realtors®' Real Estate Securities and Syndication Institute® (RESSI). Accompanying me today is Gil Thurm, Vice President and Legislative Counsel for Government Affairs for the National Association of Realtors®. The National Association of Realtors® represents more than 600,000 individuals engaged in all facets of the real estate industry and we are very interested in the possible effects which the taxation and accounting proposals currently before this Committee may have on legitimate real estate transactions.

It is important for this Committee to understand that the National Association of Realtors® and the Real Estate Securities and Syndication Institute® applaud and support the intent of the Treasury Department proposals to eliminate many currently existing taxation abuses. Our comments are directed towards those proposals which we believe may unnecessarily disrupt legitimate economically motivated real estate transactions. We should also note, as this Committee is well aware, that the real estate industry is one of the largest industries in the nation. In 1981, real estate was the fourth largest industry in the United States and accounted for $275.5 billion of economic activity. This was 12 percent of the Gross National Product (GNP) of the entire private business sector of the economy. In 1981, the National Income generated in the real estate industry and in other industries supplying it was $303 billion, about one-eighth of the total U.S. National Income.

Further, the real estate industry provided 5,966,000 jobs in 1981—about one out of 12 private sector jobs. From 1947 through 1981, employment in the industry grew at 2.1 percent per year, almost a third again as fast as in the private sector as a whole.

The National Association of Realtors® is here today representing an industry that does not traffic in tax losses. According to the Stanger Report (February 1984), for the year 1983, approximately 90% of the $4.4 billion raised through publicly offered real estate syndications did not provide any significant "spill-over losses" to limited partners. Only in a few programs, which provide equity financing for new construction, where no cash distributions could be expected by the investors for a year or more, are early tax losses present and then generally not less than .3 to $1 of original investment. According to the same Stanger Report, approximately 50% of the dollars raised in 1983 from publicly offered limited partnerships (approximately $2.2 billion) were from IRAs and KEOGHs and other pension plans where no tax motivations were present at all.

We will now address the specific provisions in the Proposals. Because no legislative language is available, our comments are based upon review of the proposals as described in the Administration's Fiscal Year 1985 Budget, the Treasury Department's release of February 17, 1984 and a pamphlet released on the same date by the Joint Committee on Taxation.

A. PARTNERSHIP PROVISIONS

1. Partnership allocations and distributions

The Administration proposes that if a direct payment by a partnership for property or services would be chargeable to capital, distributions to a partner for such property or services would be treated the same as those made in the transaction between the partnership and one who is not a partner and would have to be capitalized. We concur that abuses may occur when partnerships are structured so that payments which should be capitalized are disguised in order to be currently deducted as an allocation of income. We believe that the Administration's Proposal is a reasonable solution to a potential abuse so long as the definition of those items which must be capitalized follows current law regarding guaranteed payments. A further Proposal would treat certain contribution/distribution arrangements as sales among the partners. While the National Association of Realtors® and RESSI concur in the proposed approach, we believe careful statutory language is necessary to make sure that legitimate partnership distributions are not treated as sales. We would be happy to work with this Committee in developing the necessary statutory language.

2. Retroactive allocations

Under the Administration Proposal retroactive allocation of partnership taxable income and loss would be prevented in the case of a cash basis partnership in a tiered arrangement. We agree with the Treasury in its June 1983 testimony that there is abuse in the allocation of deductions using tiered partnerships that should be corrected legislatively. We believe this can be done without the elimination of the cash basis of accounting treatment for all parternships. However, the Treasury Proposal would provide further that all partnership allocations of income, gain, loss, etc. would have to be done on a daily basis for the year in which the partners were admitted. We support statutory restrictions to prevent retroactive allocations that address what the Treasury Department perceives to be abusive so long as they are responsive to practical business needs. However, the daily allocation Proposal, in our opinion, would provide for an unduly burdensome and unworkable situation. Further, and most important in our opinion, as many abuses may occur as a result of daily allocations as may be occurring under current tax law which allows "retroactive allocations." Mr. Chairman, a compromise with respect to the business needs and to prevent what Treasury perceives as abuses may be to allow partnerships to allocate to partners admitted to the partnership in particular time periods only those expenses and other items attributable to that time period. We suggest that the allocation of partnership items be based on periods of at least six months. The size of many real estate limited partnerships and their relatively long organizational and marketing periods require that all partners be treated equally. We believe that such periods are used for many taxpayers as part of ACRS as conventions under the Economic Recovery Tax Act of 1981. An alternative compromise could only disallow those retroactive allocations which create deductions resulting in a 50 percent or greater reduction in that individual partner's capital account. We would actively assist this Committee in exploring these suggested compromises. The result of the Treasury's daily allocation Proposal would be to force all partnerships having partners who are admitted, withdraw or change their interest during the year to use the accrual basis of accounting in order to avoid the mandatory use of uneconomic allocation methods under the Proposal. It would effectively eliminate the cash method of accounting for all partnerships (including law firms, accounting firms and other large partnerships). We believe that the drastic change will have no significant revenue gain since any deduction not allocable to one partner would be allocable to another partner. In substance, the Proposal is an attack on the cash basis of accounting which, because of its simplicity and objectivity, is used by the vast majority of taxpayers. Present law confirms the treatment that upon entry of a new partner, an interim closing of the books is acceptable and treats any cash income received or cash deductible item paid after entry by the new partner, to be allocated to all the partners in accordance with their ongoing percentages at that time. Recent tax court decisions have confirmed that with respect to deductible expenses, a partner whose capital contribution is used to pay such expenses is to receive his proportionate share of the deduction attributable to the payment. This is certainly a fair method and it is not abusive.

Examples which illustrate the impropriety and unfairness of the proposal.

(1) Assume a partnership formed on January 1, 1985, between A and B, in which each make a $10,000 capital contribution. From January 1 through November 30, 1985, the partnership incurs $30,000 of expenses which have not been paid. On December 1, 1985, C enters the partnership and contributes $10,000 for a one-third interest in the partnership. On December 31, 1985, the partnership pays the $30,000 in deductible expenses. Under present law, A, B and C would each be allocated a $10,000 share of the partnership's loss for 1985, exactly reflecting the economic substance. Under the proposal, A and B, having been partners for the entire year,

would be allocated 11/12 of $30,000 of the loss and 2/3 of 1/12 of $30,000 of the loss (or $29,167); C, having been a partner for one month, would be allocated 1/3 of 1/12 of the $30,000 loss (or $833)—an entirely artificial result which is totally contrary to economic substance.

The complexity, and simply unfairness, would, of course, be multiplied ad infinitum for a partnership where several partners enter at different times during a year.

(2) Assume the same facts as in (1) above, except that the $30,000 in unpaid bills are paid on January 1, 1986 instead of December 31, 1985. Under the Proposal, as under current law, the loss would be allocated one-third to each of A, B and C.

We do not believe that present law involving partnership retroactive allocations is susceptible to any significant abuse, except in the case of tiered partnerships. Deductions for tax purposes can be currently taken only if payments (i) are commercially reasonable in amount; and (iii) do not, when deducted, result in a distortion of the taxpayer's income.

3. Property contributed to a partnership

Under the Administration Proposal any built-in gain or loss from contributed property would be made mandatory as to allocation of such gain or loss to the contributing partner. Property that is inventory in the hands of a contributing taxpayer would retain its character as ordinary income property for five years in the hands of the partnership. The "built-in" (pre-contribution) losses of contributed capital assets would retain their character in the partnership as capital losses for five years. We support the Administration Proposals with respect to the contribution of property. However, with respect to the character of contributed property in the hands of a partnership, we believe that any gain arising from such property should only be ordinary income if it is allocated to the contributing partner. If the property would not be ordinary income property attributed by the other partners, they should be entitled to capital gain or ordinary income depending on their status as "dealiers." A rule of this type would prevent the abuse of a person escaping "dealer status" by the use of a partnership and at the same time this suggested rule would allow persons who purchase an interest in property of the partnership to treat the gain or loss attributable to such property as they would have had the property been bought outright.

4. Like kind exchanges

The Administration Proposal would treat tax free like kind exchanges as not available for the exchange of partnership interests in different partnerships. Also, gain would be recognized generally on like kind exchanges that would not conclude within 90 days after the property transferred is relinquished.

We do not believe as the Treasury does that significant abuse occurs in all like kind exchange of partnership interests. In recent years several decisions of the Tax Court have provided that non-recognition treatment should be available, at least where the holder of a partnership interest is actively engaged in the partnership business as a general partner rather than a passive limited partner and the underlying assets of the partnership would qualify for non-recognition treatment under Section 1031. We see no reason to legislatively overrule these cases since it is our understanding that what is being accomplished by an exchange of such partnership interests could be alternatively accomplished through other Code partnership provisions and achieve the same result. A general partnership interest constitutes a bundle of rights possessed by an active partner in the trade or business of the partnership. These rights and obligations are not the same as that of an owner of stock or securities which currently are excluded from the tax free provisions of Section 1031. A general partner has the right to manage the partnership business and is obligated to pay the partnership liabilities. Clearly, such an active involvement in the partnership business is more akin to a proprietary interest than an investment in stocks or securities. Moreover, the courts have consistently held that general partnership interests may qualify for tax free exchange treatment under Section 1031 of the Code. The courts have applied a substance versus form analysis whereby the underlying assets of the partnerships are compared and have concluded that an interest in a real estate partnership may not be exchanged under Section 1031 for an interest in a partnership that, for example, invests in marketable securities. Further, the liabilities are compared to determine if the exchange results in the receipt of boot. We believe that as a result of the interpretation of Section 1031 as to the exchange of partnership interests, there is little potential for abuse. It is our recommendation that no action be taken other than a codification of current case law as there is no apparent abuse associated with the exchange of partnership interest. As stated above, there are other methods under the partnership sections of the Internal

Revenue Code to affect the same result so that the proposed change will not result in any significant increase in revenue.

With respect to the deferred non simultaneous exchanges, the National Association of Realtors supports the Treasury position that the five years exchange period allowed under the *Starker* case is too long. However, we believe that the 90 day period contained in the Administration Proposal is generally not long enough to negotiate and close a real estate transaction. It often takes many months to find suitable property in the present real estate market and several months after that to negotiate and complete the acquisition of the property. A 24-month period (comparable to Section 1031) rather than the 90 day proposal would be a more reasonable time to allow for the acquisition of such property and would not unduly prolong the closing of the transaction. It is our recommendation that a 24 month period would achieve the intent of the statute and avoid the taxing of paper profits in legitimate like kind property exchanges.

B. ACCOUNTING REFORMS

1. Deferred payments

The Administration Proposal on deferred payments would expand the scope of the original issued discount rules ("OID") to include the purchase or use of property or services for discount obligations when neither the property nor the services nor the obligations are publicly traded. This would mean that the seller of property on the installment basis would have to report as taxable income all interest accrued on the installment obligations (whether or not received) even if he is a cash basis taxpayer. In such cases, the amount of interest which is deemed to accure would be determined by reference to the interest rates under Section 483 and would be computed on a compound interest basis rather than the current law simple interest basis. The Committee should be aware that many states, including New York and Illinois, do not allow the compounding of interest rates on sales of real property. We also favorably note that the Administration's Proposal for expanded OID rules would exclude, among others, sales of farms by individuals or closely held businesses, sale of principal residence by individuals and sales involving payments of $250,000 or less.

The National Association of Realtors supports the deferred payment Proposal with respect to the buyer deduction side of the transaction. However, as noted above the proposal would also require a cash basis seller to be taxed on "phantom income." We believe such a rule would impose an undue burden on sellers who finance the sales of their property and would interfere with a significant part of the financing available in many real estate transactions. The Administration's Proposal somewhat reflects an awareness of the potential interference with business realities. However, we believe that the exceptions in the Proposals are not sufficient to solve the problem that the OID rule extension would create. By applying the OID rules as proposed to the sale of real estate, many sellers would not be able to sell their properties and receive sufficient cash to pay the taxes accruing on the phantom income created by the deferred payment obligation. Economically troubled businesses likely would be prohibited from negotiating the deferral of payments to creditors and suppliers who are willing to assist the business in surviving recessionary periods. In addition, if a cash basis recipient of deferred payments is required to recognize as taxable income the accrued amounts which the seller would be required to deduct under the OID principles, such inclusion will overstate and distort income under the cash method of accounting. We also question how the Administration proposal would handle situations where because of government subsidies or state subsidies, the seller cannot receive sufficient revenues from the buyer to allow the seller even to cover the income taxes on the deferred payments that the seller has taken back in connection with the sale of the property. A significant portion of loans made by independent third party lenders in the current economic climate include an element of accrued interest which is not paid on a current basis. There are numerous examples which establish that these debts are not being issued primarily for federal income tax purposes, but for economic reasons in order to keep cash flow deficiency at a minimum and to allow for the development of and the acquisition of new properties. The forcing of lenders to pick up such accruals as current income would, in our opinion, result in significant cash flow deficiencies to the lenders since the tax on the interest might exceed the cash received and would most probably eliminate the opportunity for such beneficial financing to borrowers in need of financing.

The perceived abuse that the administration is addressing by extending the OID rules is to prevent the accrual basis taxpayer who purchases property or services and who makes substantially deferred payments from claiming an overstated deduction. On the seller's side, no such distortion exists with respect to the services or the property. Therefore, we believe that a reasonable compromise would be to extend the OID rules to the purchaser's side of the transaction, but allow the seller who is a cash basis recipient not to recognize taxable income on the accrued amounts. We believe such inclusions would necessarily overstate and distort the seller's income under the cash basis of accounting. The dramatic effect of the adoption of the OID rules for cash basis sellers would upset long settled and well understood accounting practices. The National Assocation of Realtors and RESSI do not support abusive tax shelters. Rather, we believe long established accounting principles known to many should be respected. Moreover, the Internal Revenue Service has significant tools to fight accrual abuse with the power under Code Section 446(b) through the Commissioner's ability to have taxpayers change accounting methods for income tax reporting to a method which "clearly reflects income."

2. Prepayment of expenses

The deduction of prepaid expenses prior to the period to which expenses are allowable would under the Administration proposal be prohibited to "syndicates" other than farming syndicates. This prohibition would apply to both cash basis and accrual basis taxpayers.

We agree that the prepayment of expenses has the potential for abuse. However, there are many instances where legitimate and customary business practices make the prepayment of expenses bona fide for nonrelated tax reasons. Many forms of insurance and real estate taxes are prepaid one year in advance. Similarly, many prepayments occur to simplify billing and bookkeeping, to obtain lower prices, to obtain discounts and to handle administrative problems of the payor as well as the payee. We believe that there is sufficient distinction in current case law between the test set forth in the Zaninovich case and those cases rejecting voluntary prepayment for tax reasons. We suggest that the prepayment of expenses for up to one year after the date of payment as being currently deductible be considered by the Committee. Such a rule solves the administrative nightmare that would occur for many innocent taxpayers who would not be aware of the prohibition against the deduction of prepaid expenses. To apply the prepayment Proposal only to "syndicates" discriminates against the small man who can only pool his resources with other investors and favors the rich who can operate outside the syndicate form. A one year rule would be a reasonable and appropriate standard which would eliminate the potential abuse involving the prepayment of expenses for many years in advance. Additionally, such a rule would not impose a costly and burdensome requirement on legitimate business transactions where there are bona fide business reasons for the prepayments.

3. Related party rules

Under the Administration Proposal, taxpayers subject to this provision will be required to defer deductions for accured interest and expenses owned to a "related" taxpayer until the amount is actually paid. The definition of "related parties" would be expanded to include partners, partnerships and controlled corporations regardless of the amount of common ownership. It is essential that some form of de minimus exception be provided for common partnership interests. We propose a minimum 10% ownership of capital and profits which is similar to the percentages in the anti-churning provision of Section 168(e)(4) of the Internal Revenue Code for related parties. The 10% minimum reduces the possibility that parties will become related inadvertently as, for example, through the purchase by one person of investing units in a new partnership which is the owner of property in which the person has or even formerly had an interest. Moreover under the Subchapter S Revision Act of 1982, Section 267 of the Code was amended to provide that amounts accured by an S corporation for payment to any cash basis shareholder owning two percent or more of the corporation stock, including shares constructively owned under Section 267(c) would be deductible by the corporation only when actually paid to the shareholder and includable in his gross income. If the Administration Proposal is adopted as set forth, there will be a discrimination between the ownership in related partnerships and the ownership in related corporations. In corporations there must be a 50% common ownership for the section 267 provisions to apply. We are aware that H.R. 4170 currently contains provisions similar to the Administration proposal. We suggest that enactment of these provisions without any *de minimus* exception does not appear to be fair and we urge the Committee to adopt, either through technical amendment or in Conference with the Senate, a minimum common ownership test of at least 10%.

4. Premature accruals

The Administration Proposals would clarify the "all events" test to provide that no deduction be allowed until economic performance occurred. A deduction would be permitted when services are performed or when the use of property occurs. An exception to this rule will be provided for a case in which economic performance will occur within one year after the end of the taxable year.

We support the Administration's Proposal to restrict deductions where economic performance has not occurred. We would appreciate clarification so that interest on the forebearance of money is intended to be included in the Administration's Proposal on deferred payment sales and not premature accrual provisions. Otherwise, there would be a drastic affect on the real estate industry where purchase money obligations or third party obligations involving accured but unpaid interest are used. As we understand the Proposals, Section 483 on deferred payment sales would cover interest and other types of premature accural items would fall under this Proposal. We believe clarification of these provisions is certainly necessary.

C. EFFECTIVE DATES

In the event any of the provisions today before this Committee are adopted as proposed, we strongly urge that the provisions contain effective dates no earlier than the date of enactment in order to be fair to all taxpayers and to give taxpayers time to modify pending business transactions. Many transactions that are presently being planned and/or consummated would be effected by the Proposals. These provisions should be "grandfathered" by appropriate clauses to protect transactions entered into pursuant to contracts which are binding on taxpayers on the effective date and transactions pursuant to which properties have been acquired or construction, reconstruction or other types of activity begun. We are aware that a small number of transactions will be entered into before the effective date, but the problems of curtailing legitimate business activity by imposing retroactive effective dates are far greater than the few transactions which would get the benefits of a grandfather clause.

Mr. PEASE. Thank you very much, Mr. Fass.

Our next witness will be Mr. Lawrence Simons of the National Multi Housing Council.

STATEMENT OF LAWRENCE B. SIMONS, LEGISLATIVE COUNSEL, NATIONAL MULTI HOUSING COUNCIL

Mr. SIMONS. Thank you, Mr. Chairman, for the opportunity to appear before you today to discuss the administration's proposals with regard to tax shelters and the impact they have on the development and preservation of rental housing in this country.

I am appearing on behalf of and as legislative counsel to the National Multi Housing Council, a nationwide organization of developers and operators of rental housing.

In my 4 years serving as the Federal Housing Commissioner, one of my primary concerns was the absence of incentives for the production and preservation of conventional rental housing in this country.

Because rental projects tend to serve primarily lower income groups, because they are generally perceived to be a risky form of real estate investment, and because of the substantial tax incentives which the Internal Revenue Code provides for homeownership, there was little incentive for the market to invest either in the preservation of existing rental or in the production of new rental stock.

The results were the steady decline in the production of unsubsidized rental housing, severely tight rental markets, and increased deterioration of the existing rental stock. I am happy to tell you today that while this scenario did describe what took place in rental housing from the early seventies through the first years of the eighties, it is clear that thanks in large measure to the work of this committee, the decline in rental housing has been stopped for the time being, at least.

Primarily because of the enhanced incentives for investment in rental housing, which this committee wrote into the ACRS provisions of the 1981 Tax Act, it is feasible once again to build new rental housing, to maintain it in decent condition, and to preserve it as rental housing. Particularly in the last year and a half, when the ACRS provisions were aided by the availability of tax-exempt financing and the drop in interest rates from the record levels of 1981 and 1982, rental housing has once again become a competitive investment.

The pent-up demand from years of inadequate rental production has meant a substantial increase in the production of new housing, despite the termination of federal housing programs.

In short, Mr. Chairman, the rental housing incentives which this committee put into the law are beginning to work. Production is expanding. People are once again employed in building multifamily housing, and historically tight markets have eased. Unfortunately, there is a long way to go to fulfill this Nation's housing needs, and what I would like to address today are the proposals which the administration in their most severe form might threaten this long overdue recovery for rental housing.

Tax shelters are always an easy target. The very term conjurs up visions of people escaping taxation by illegitimate means, but in the current market, Mr. Chairman, so-called tax shelters are the means by which the housing industry makes use of incentives which you have wisely put into the law.

The limited partnership device, the choice of accrual or cash basis accounting, the allocation of a substantial economic basis for the various aspects of housing ownership, and the division of investments and responsibilities between general partners who develop and manage projects and limited partners who provide the investment capital are the means by which the tax incentives for rental housing are made effective.

Therefore, when this committee is called upon to consider changes in the laws governing tax shelters, it is essential that these changes be considered in the context of their very real policy impact on the producers and consumers of rental housing alike. It is in this context that my testimony, which you have before you, reviews some of the Treasury tax shelter proposals. I would just like to mention a couple of those.

The OID rules as it relates to housing would cause a serious impairment to building new housing as well as what to do with existing housing. I was formerly a developer, and I developed many multifamily projects. When you develop multifamily housing, you are going to worry about the ultimate outcome of where you can dispose of it. Reducing the ability to sell that project reduces the incentive to build it in the beginning.

Second, the importance of being able to sell projects and then able to refinance the physical needs of that project become essential for the preservation of stock.

I would like to just say this. We have a long way to go with multifamily housing. We have begun to make some inroads into it. Do not undo what you have so capably done to date. Be very careful with whatever you do with these proposals now before you, as they affect the syndication of multifamily housing.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF LAWRENCE B. SIMONS, ON BEHALF OF THE NATIONAL MULTI HOUSING COUNCIL

Mr. Chairman, Members of the Committee, I am honored to appear before you today to discuss the Administration's proposals with regard to tax shelters and the impact they would have on the development and preservation of rental housing in this country. I am appearing on behalf of and as Legislative Counsel of the National Multi Housing Council, a nationwide organization of developers and operators of rental housing.

In my four years as the Federal Housing Commissioner, one of my primary concerns was the absence of incentives for the production and preservation of conventional rental housing. Because rental projects tend to serve primarily lower income groups, because they are generally perceived to be a risky form of real estate investment and because of the substantial tax incentives which the Internal Revenue Code provides for home ownership, there was little incentive for the market to invest either in the preservation of existing rental housing or in the production of new rental stock. The results were the steady decline in the production of unsubsidized rental housing, severely tight rental markets and increased deterioration of existing rental stock.

I am happy to tell you today that while this scenario did describe what took place in rental housing from the early 1970s through the first years of the 1980s, it is clear that, thanks in large measure to the work of this Committee, the decline in rental housing has been stopped.

Primarily, because of the enhanced incentives for investment in rental housing which you wrote into the ACRS provisions of the 1981 Tax Act, it is feasible once again to build new rental housing, to maintain it in decent condition and to preserve it as rental. Particularly in the last year-and-a-half, when the ACRS provisions were aided by the expanded availability of tax-exempt financing and the drop in interest rates from the record levels of 1981 and 1982, rental housing has once again become a competitive investment. The pent-up demand from years of inadequate rental production has meant a substantial increase in the production of new housing, despite the termination of Federal housing subsidy programs.

In short, Mr. Chairman, the rental housing incentives which you have put into the law are working. Production is expanding. People are once again employed in building multifamily housing. And historically tight markets have eased.

What I would like to address today are recent proposals by the Administration which, in their most severe form, might threaten this long overdue recovery for rental housing.

Tax shelters are an easy target. The very term conjures up visions of people escaping taxation by illegitimate means. But in the current market, Mr. Chairman, so-called tax shelters are the means by which the housing industry makes use of the incentives which you have wisely put into the law. The limited partnership device, the choice of accrual or cash basis accounting, the allocation—on a substantial economic basis—of the various aspects of housing ownership, and the division of investments and responsibilities between general partners, who develop and manage projects, and limited partners, who provide the investment capital, are the means by which the tax incentives for rental housing are made effective.

Therefore, when this Committee is called upon to consider changes in the laws governing tax shelters, it is essential that these changes be considered in the context of their very real policy impact on the producers and consumers of rental housing. It is in this context that I would like to review briefly with you the Treasury tax shelter proposals.

First, while not included among the Treasury proposals, there has been some discussion of increasing the ACRS recovery period for existing rental housing from fifteen to twenty years. Such a change would undo much of the progress that has been made since the passage of the 1981 Act. New investors would be harder to find for existing rental properties. The pace of condominium conversions would accelerate, accompanied by a loss of rental stock. In a number of instances, rents would have to increase in order to support existing housing.

On the last point, a 1982 HUD study entitled "Federal Tax Incentives and Rental Housing" pointed out the direct consumer benefit of the ACRS provisions in the 1981 Act. The study found: "It is likely that most of the benefits to owners and investors under ERTA will accrue to tenants in the form of lower rents than would be the case without ERTA." (p. vi) The study went on to point out: "Given the competitive nature of the rental housing market, it is likely that most of the benefits of rental-specific tax provisions accrue to renters . . . Since renters have lower incomes than other households, tax benefits that lead to decreased rents tend to be progressive in nature." (p. v)

There has been some suggestion that rental housing, particularly existing rental housing, may have benefitted "too much" from the 1981 Act. As evidence for this, some people point to a high volume of transfers of existing rental properties over the past several years and the recent sharp growth in rental production. As I noted at the outset, a series of factors have contributed to the growth in rental production. This growth is something that is long overdue and highly welcome, rather than the sign of a problem. The large numbers of transfers of existing rental housing in recent years stem, first, from the extraordinary high interest rates which discouraged any sort of new construction. Thus, investors in real estate looked to existing rental housing.

In addition, large numbers of Federally-subsidized projects, which went into service between 1970 and 1975, have reached the point at which they need major expenditures for maintenance and preservation, and at which their initial tax benefits have run out. As a result, these projects are severely in need of new investment, investment that was made possible through purchase and realization of tax benefits.

Finally, I would point out that the Library of Congress and other authorities found that the 1981 Tax Act put real estate generally at a relative disadvantage vis-a-vis investments in equipment and personal property. Thus, while tax incentives for investments in real estate improved under the 1981 Act, other investments received even more substantial increases. To cut back on housing's incentives, by lengthening the ACRS life for existing housing, would further disadvantage this vital source of shelter for America's low and moderate income families.

Let me deal with the specific tax shelter proposals put forth by the Administration. A proposal that has a serious impact on rental housing is that which would apply the original issue discount rules, and make certain other changes, with regard to deferred payment transactions. Under this proposal, the seller of property on the installment basis, that is, a seller that took back secondary financing, would have to report as taxable income all interest accrued on the secondary financing, whether or not received, even if he were a cash basis taxpayer. In addition, the amount of interest attributed to a particular transaction would be computed on a compound rather than simple basis.

In order to appreciate the impact of these proposals, it is essential to understand that most existing rental housing is sold with the seller taking back a significant purchase money mortgage. Rental housing in many cases is simply not a sufficiently desirable investment to attract affordable third-party financing. In addition, for most rental housing, a project can support on a current basis—that is, through increased rentals—little or none of the interest due on the purchase money mortgage. Thus, interest on the second mortgage is usually accrued rather than paid directly. This interest is paid several years hence, frequently when the project is resold.

Against this background, we can appreciate the impact of the Treasury proposal. First, project sellers who took back accrual mortgages would be taxed on the basis of income which they did not receive. Second, the basis of the property in the hands of the new owners would be decreased, since the interest component of the mortgage would be arbitrarily computed at a compound rate. This reduction in tax incentives will limit the ability of the purchases to raise capital for needed improvements. In short, the incentives which you put into the law for the preservation of existing housing would effectively be frustrated, and the housing permitted to deteriorate.

It is entirely appropriate for both the Congress and the Treasury to be concerned about abusive transactions, in which interest is accrued but never paid and values are inflated artificially. You have, however, given the Internal Revenue Service increased enforcement and penalty powers to deal with this situation. In addition, if you believe that further action is needed to prevent abuses in this area, I would recommend that you exclude rental housing from any such changes. For most rentals there is simply not the cash flow with which to pay the interest accruing on a second mortgage. For these projects, the Treasury proposal will lead to owner disinvestment.

Going briefly to the rest of the proposals, we support the recommendation that the law be clarified to prevent the conversion of a payment, which would be normally chargeable to capital, into an allocation of income when the particular service is performed by a partner. Partnerships should not be permitted to be structured to enable capital costs to be deducted as distributions of income. I would note, however, that this support assumes no change in the definition of items which must be capitalized as opposed to those which may be deducted directly.

We do not support the Administration proposal on so-called "retroactive allocations." Indeed, I believe even the title of this particular provision is misleading. What the provision would do is deny a deduction to a partner for an item which was paid after that partner entered the partnership, but the obligation for which was incurred prior to the partner's entry. In other words, a cash basis partnership which paid an expenditure with money invested by a particular partner could nonetheless not allocate that expenditure to that partner, solely because the obligation to make the expenditure was incurred prior to the partner's entry.

This is contrary to sound principles of cash basis accounting, and ignores the basic practice of limited partnerships in which general partners carry on the operations of a partnership, incurring obligations, in the expectation that these obligations will be paid with the cash of investor limited partners, as they enter the partnership.

Beyond the fact that it is simply wrong, the Administration proposal is also unworkable. It would require all accounting for expenses and income to be done essentially on a daily basis, a daily accural basis, since partners would not be entitled to deductions for expenses accrued prior to their entry to the partnership. This is an impossible administrative burden. At worst, the provision should operate on a semiannual basis, permitting investor limited partners the benefit of expenses paid after their entry, the obligations for which were incurred during the six month period within which they entered the partnership.

The proposal with regard to property contributed to a partnership is basically sound, in that it would prevent a partner from changing the nature of a gain or loss on a particular piece of property simply by contributing it to a partnership. Clearly, built-in capital gains or losses on property should retain their character in the contributing partner's hands. In addition, gains or losses attributable to that property for five years subsequent to the contribution should also be treated for tax purposes, for the contributing partner, as if the contribution had not been made. However, contrary to the Treasury proposal, we would suggest that this property be treated for the purposes of other partners in the partnership in the same fashion as any other comparable piece of property. In other words, we would deny the contributing partner an unjustified tax benefit from his contribution, but equally we would not penalize the remaining members of the partnership because of the pre-partnership tax status of the contributed property.

We agree with the premise underlying the proposal vis-a-vis like-kind exchange of partnership interests, but would suggest one change. Where the exchange involves the interests of investor limited partners, there is clearly no basis for distinguishing such a transfer from comparable transfers of other types of securities. Therefore, we would agree that such exchanges should be denied tax-free treatment. However, where general partners exchange or reorganize interests, and the underlying assets of the partnership would qualify for Section 1031 treatment under current law and court decisions, we would argue that such exchanges should continue to qualify for non-recognition treatment.

In addition, while we agree that the five year period now permitted within which like-kind exchanges of property may take place is too long, we believe the three months contained in the Administration proposal is simply not adequate to negotiate and close a real estate transaction. If the particular contemplated exchange falls through, if there is a difficulty in securing financing, if there are questions about title, the proposed exchange could not be consummated and both parties would sufer tax penalties. We would recommend that a one year period be substituted. We also feel, consistent with the problems raised, that no "specific designation" of property should be required to take place prior to this time.

We believe the Administration proposal on premature accruals of expenditures will serve to close a potential loophole in the current law. Where a contract is entered into but neither party is required to perform for a substantial period of time, it does not seem to us to be defensible to permit a tax deduction. Where economic performance has taken place, that is, where one side of a transaction has performed, an accrual deduction should be permitted. We understand this to be the thrust of the Administration's proposal and we support it.

We believe the Administration proposal on prepayments of expenses is unnecessary and particularly unfair to real estate. Many expenses for property, such as taxes and hazard insurance, are normally prepaid on an annual basis. Taxpayers should be permitted to deduct cash payments of expenses, when the goods or services are received within the subsequent taxable year. Note, we are not talking about services received many years in the future, but simply in the subsequent year.

Finally, I know you will have other testimony on the question of sales of property in which a member of the selling partnership also has an interest in the acquiring partnership. I would only add that, while at HUD, I believed it desirable to encourage the managing partner of a well-managed project to continue in that role, even after the project changed hands. That continues to be HUD policy, and I believe it is a sound one. The effect of the proposed rule, which your Committee has already included in H.R. 4170, is to penalize acquiring partnerships if the managing partner retains an interest in a project. I would urge that you adopt an appropriate de minimus rule, which would allow a selling partner to stay with the project if he holds no more than, for example, a five percent interest in the acquiring partnership.

Mr. Chairman, I request permission to insert for the record a lengthier analysis of the Administration's tax proposals. I appreciate your courtesy in hearing me out. Thank you very much.

Mr. PEASE. Thank you, Mr. Simons.

Next we will have Stephen Smith of the Coalition for Low and Moderate Income Housing, and the National Leased Housing Association. Mr. Smith.

STATEMENT OF STEPHEN B. SMITH, MEMBER, EXECUTIVE COMMITTEE, COALITION FOR LOW AND MODERATE INCOME HOUSING, AND MEMBER OF THE BOARD AND CHAIRMAN, SYNDICATION COMMITTEE, NATIONAL LEASED HOUSING ASSOCIATION, ACCOMPANIED BY BRUCE S. LANE, COUNSEL

Mr. SMITH. Thank you, Mr. Chairman.

My name is Stephen Smith. I am president of the Investment Group of Washington, D.C. We act as developers and syndicators of all types of low and moderate income housing. I am here today in my capacity as a member of the executive committee of the Coalition for Low and Moderate Income Housing, and as a director of the National Leased Housing Association. I am accompanied by counsel for both organizations, Mr. Bruce Lane of the Washington law firm of Lane and Edson.

Among the proposed changes in the tax law being considered by this committee are three proposals which we feel would cripple the production, rehabilitation, and preservation of low and moderate income housing. Those three proposals relate to, first, deferred interest payments, second, interest going to related parties, and third, lengthening the ACRS recovery period.

The coalition and the NLHA strongly believe that these proposals should provide exemptions for low and moderate income housing for reasons I will explain. We have estimated that the revenue losses for such exemptions would be extremely small.

The first proposal I would like to address is that entitled "Treatment of Interest Attributable to Deferred Payments." If this proposal were enacted, we feel that there is likely to be greater deterioration of existing properties and more Government foreclosures of low and moderate income housing properties. The proposal before the committee would extend the original issue discount rules to substantially all purchase money loans used in connection with most purchases of low and moderate income housing, and would force sellers to include as taxable income all of the accrued interest which may be deducted by the buyer, even if the seller is a cash basis taxpayer and even if the seller gets no cash to pay his taxes.

When a low income housing project is purchased, the sellers generally take back a purchase money note secured by the equivalent of a second mortgage on the property. The use of the purchase money note allows the new partnership which is purchasing the property to use less of the cash raised from the new investors to pay the old owners, and to spend more of it on upgrading the property.

The interest on the purchase money note will accrue but cannot be paid currently for two reasons which are peculiar to low and moderate income housing. First, because the low income tenants cannot afford higher rents, and second, because the regulations governing subsidized housing typically limit the cash distributions to owners and do not permit project income to be used to pay interest on such financing.

I would like to point out most importantly that HUD reviews the financial arrangements of these types of purchases, including accruals of interest on purchase money notes, because HUD recognizes that the purchasing partnerships will not normally be able to pay currently all of the interest on the purchase money financing and must accrue a part of it. HUD reviews the price paid, including the financing, to ensure that the value of the housing project will support the debt and accrued interest of the new partnership.

The legislative proposal before the committee would require that the sellers of a low income housing project would incur "phantom" income and pay taxes on that income each year even though they do not receive any cash. If this proposal is enacted, many if not all low income housing projects which are desperately in need of cash infusions will not be transferred because existing owners will elect to retain these projects rather than incur an additional unfunded tax liability.

The result will be further deterioration of these projects, higher rents to low income tenants, and increased default rates at a direct cost to the Federal Government. What would be the revenue impact of a low income housing exemption to this proposal? We have estimated that even on a worst case analysis it is unlikely that an exemption for low and moderate income housing would result in a revenue reduction of more than $10 million to $15 million per annum.

Moreover, this figure for revenue loss does not take into account the revenue gain when the seller in the resyndication process pays tax on the profit involved in his sale. A recent analysis indicates that resyndication of existing apartment buildings to take advantage of the depreciation provisions of the 1981 Tax Act will have little or no net impact on Federal tax revenues.

In addition, Mr. Chairman, you cannot ignore the revenue impact to the Federal Government if there are foreclosures of deteriorating properties. Without the current revitalization program, more and more units can be expected to be foreclosed by HUD.

The second proposal I would like to address quickly relates to a requirement that partnerships defer deductions from accrued interest and expenses owed to a related taxpayer until actually paid, including partners with even an insignificant ownership interest. It is vitally important in our view that if the exemption for low and moderate income housing is granted from the deferred payment proposal above, a similar exemption be granted from the related party proposal. Otherwise, the related party proposal would prevent an existing general partner who may have been an effective owner-manager of the property from remaining as a general partner of the new partnership.

The third proposal that I would like to address is one that would extend the real property cost recovery period from 15 to 20 years for used structures. The impact of this proposal would be particularly harsh on rental and low income housing because it would substantially reduce the incentive to invest fresh capital in order to rehabilitate, modernize, and in some cases prevent defaults on older HUD properties.

Such older properties are precisely the ones which need the benefits now provided under the current cost recovery period of 15 years.

Finally, Mr. Chairman, I would like to reiterate our support for the extension of section 167(k) of the Internal Revenue Code allowing the writeoff over 5 years of substantial rehabilitation costs for low and moderate income housing projects. As you know, this provision of the Code expired on December 31, 1983, and we feel that it is imperative that it be reinstated in order to give the necessary tax incentives for those low and moderate income housing projects requiring substantial rehabilitation.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF STEPHEN B. SMITH, ON BEHALF OF THE COALITION FOR LOW AND MODERATE INCOME HOUSING AND THE NATIONAL LEASED HOUSING ASSOCIATION

Summary

1. There continues to be a shortage of multi-family rental housing in the United States for families and individuals of low and moderate income. Without governmental assistance such housing cannot be provided.
2. Although Low and Moderate Income Housing has, in the past, received both direct subsidies (e.g., the Section 8 Housing Program) and indirect subsidies through tax incentives, most of the direct subsidies have been either eliminated or drastically reduced.
3. Thus, the tax incentives, including the enactment of ACRS and its extension to existing housing, are the only real government assistance left for the process of preserving and/or rehabilitating existing housing.
4. In the process of preserving and revitalizing our existing housing stock, the new partnerships purchasing the housing must execute purchase money notes to the sellers; and because of the restrictions on cash flow required by HUD, the interest on these notes cannot be paid currently.
5. The proposal on deferred payments would require sellers to report as taxable income the interest accruing on these notes, even though the seller gets no cash to pay his taxes.
6. If this proposal is enacted, many low income housing projects which are desperately in need of cash infusions will not be transferred because existing owners will elect to retain these projects rather than incur an additional tax liability. The result will be further deterioration of these projects, higher rents to low income tenants and increased default on federally-insured mortgages—at a direct cost to the federal government.
7. This proposal should contain an exemption for low-income housing. We have estimated that the revenue losses for such an exemption would be extremely small.
8. The proposal on related parties should also contain an exemption for low income housing. Otherwise, existing owner/managers cannot be retained as general partners of the partnership owning the property.

9. A private analysis indicates that continuing the ACRS benefits for existing housing does not result in a significant revenue loss to the Treasury. These benefits should be continued for all housing.

10. Section 167(k) of the Code, which encourages rehabilitation of existing low income housing, should be extended to preserve our existing housing stock.

Statement

A number of proposed changes in the tax law are being considered by the House of Representatives Committee on Ways and Means and the Senate Committee on Finance. Among these are three proposals which would cripple the production, rehabilitation and preservation of low and moderate income housing. The Coalition for Low and Moderate Income Housing and the National Leased Housing Association submit that these proposals should provide exemptions for low and moderate income housing for the reasons stated below. Each of these three proposals and their effect on low income housing are briefly described below. This statement also sets forth the reasons for an exemption and the estimated revenue losses for such an exemption. Finally, we suggest technical language defining low income housing for purposes of these exemptions which incorporates current definitions in the Internal Revenue Code; this is attached as Exhibit A.

The Coalition for Low and Moderate Income Housing (the "Coalition") brings together in a single coalition all associations, trade groups, business organizations, and individuals, as well as associated professionals, involved in private sector financing, production, rehabilitation and operation of government assisted low and moderate income multi-family rental housing.

The National Leased Housing Associates ("NLHA") is an organization of approximately 800 members, which represents almost all aspects of the industry associated with the development, construction, ownership and operation of low and moderate income multi-family rental housing subsidized through the various federal housing programs.

Together, the two organizations encompass virtually this entire field of endeavor, and thus can speak about it with a considerable amount of confidence and authority.

I. BACKGROUND

For over two decades, Congress has attempted to subsidize the production and operation of low and moderate income housing in a variety of ways, but all of the subsidies have taken two basic courses: direct subsidies, such as the HUD Section 236 Program, the HUD Section 8 Program, the Section 515 Farmers Home Administration, and similar state and local programs; and indirect subsidies, primarily through incentives contained in the federal income tax law.

During the past two years substantially all of the direct subsidies have been phased out by the Administration and by Congress. Accordingly, the only meaningful subsidies remaining are those provided through the Internal Revenue Code.

Were it not for the adoption of the Accelerated Cost Recovery System and the extension of that system to existing as well as new construction in 1981, it is highly unlikely that there would be any production of low and moderate income housing today, and the existing housing stock would be deteriorating rather than being improved and recycled. Indeed, it is the recycling of existing housing stock which has done the most lately to deal with the nation's housing needs, both low income and conventional. The conversion to housing of buildings originally built for another use, such as warehouses, hospitals and office buildings, and the renovation of existing apartment buildings are creating much of the housing stock of this country today, particularly in the older states and cities.

II. HUD STUDY

A study was done on these tax incentives in December, 1982, by the Office of Economic Affairs of the Office of Policy Development and Research of the Department of Housing and Urban Development (the "HUD Study"). A copy is attached as Exhibit B. It is entitled "Federal Tax Incentives and Rental Housing." This HUD study states:

"The pre-1981 tax laws favored investment in new housing over existing housing and owner-occupany over rental-occupancy. Analysis suggests that the pre-1981 tax laws may have led to a reduced demand for existing rental housing. Such reduced demand may have increased the rate of economic depreciation of existing rental housing units and was probably one of the factors leading to an increased level of abandonment and demolition of older existing units in the early 1970's.

"The 1981 tax law greatly reduces the previous large capital recovery differentials between new and existing rental housing. It encourages a succession of owners for a rental housing property to initiate a new depreciation cycle every 15 years. *This could result in a reduction of economic depreciation and longer economic life for existing rental housing units. Longer economic life may result in decreases in housing abandonment, and retention of more older units in the inventory.*" (Emphasis added) (page iii)

The HUD study concludes that the present tax incentives foster the process of preservation and rehabilitation of existing rental housing developments, including housing for persons of low and moderate income under Federal government assistance programs. The HUD study also concludes that, *"Given the competitive nature of the rental housing market, it is likely that most of the benefits of rental-specific tax provisions accrue to renters."* (Emphasis added) (page v.)

III. PROPOSAL REGARDING TREATMENT OF INTEREST ATTRIBUTABLE TO DEFERRED PAYMENTS

This proposal would extend the original issue discount rules (Internal Revenue Code Sections 163(e) and 1232A) to substantially all deferred interest payments traditionally used in connection with large real estate transactions and most purchases of low and moderate income housing. For all purchase money loans or other secondary financing, this proposal would permit less accrued interest to be deducted in the early years and more to be deducted in the later years of the loan. More significantly, the amount of such accrued interest which may be deducted by the buyer would have to be included in the income of the holder of the debt, even if that holder is a cash basis taxpayer.

A. Impact of the proposal on low income housing

When a low income housing project is purchased, the sellers, typically cash basis individuals or partners, generally take back a purchase money note secured by the equivalent of a second mortgage on the property. The use of the purchase money note allows the new partnership which is purchasing the property to use less of the cash raised from the new investors to pay the old owners and to spend more of it on upgrading the property. The interest on the purchase money note will accrue, but cannot be paid currently for two reasons peculiar to government assisted low income housing—first, because the low income tenants cannot afford higher rent levels, and second, because the federal and state regulations governing assisted housing restrict the amount of the cash distributions to owners and do not permit project income to be used to pay this interst. (The purpose of these regulations is to ensure that the project income is devoted to maintenance and operation of the dwelling units.) Thus, even if a low income project could generate sufficient income to pay a portion of interest on the secondary financing, regulatory restrictions would generally permit only a small fraction of that sum to be paid out.

As part of its transfer of Physical Assets process, HUD reviews the financial arrangements of these purchases of existing federally-assisted low and moderate income housing, including the accruals of interest on the purchase money notes. Because HUD recognizes that the purchasing partnerships will normally not be able to pay currently all of the interest on the purchase money financing and must accrue a part of it, HUD reviews the price paid, including the financing, to ensure that the value of the housing project will support the debt and accrued interest of the new partnership.

The legislative proposal on deferred payments treats purchase money mortgages as original issue discount obligations, thereby requiring that the seller recognize current income equal to the interest deductions claimed by the buyer. Since regulatory restrictions on low income housing projects effectively prevent buyers from paying the sellers cash to cover this tax liability, the sellers of a low income housing project would incur "phantom" income requiring the payment of actual taxes each year, without receiving cash with which to pay them. Thus, sellers will be penalized for financing a sale or their property.

Since the existing owners have no additional obligation as limited partners to contribute funds to a low income housing project they will be unwilling to consent to a transfer which would give rise to out-of-pocket tax liability each year without generating any corresponding income. If this proposal is enacted, many low income housing projects which are desperately in need of cash infusions will not be transferred because existing owners will elect to retain these projects rather than incur an additional tax liability. The result will be further deterioration of these projects, higher rents to low income tenants and increased default, on Federally-insured mortgages—at a direct cost to the Federal Government.

Today, as part of these purchases by new investors, HUD can cause deteriorating projects to be refurbished and thus avoid these potential government foreclosures of these projects. With the thousands of existing low and moderate income housing units insured by the Federal Government, foreclosures of many older projects because of abandonment or deterioration could be extremely costly to the Federal Government. Accordingly, for reasons of cost-effectiveness, as well as conservation of our housing stock, the HUD study supports the Code's present tax incentives, which encourage transfers of existing rental housing to new partnerships.

In addition, the proposal regarding deferred payments would also adversely affect the present tax incentives for low income housing in another way. As stated above, the proposal would change the rules for computing accrued but unpaid interest on such secondary financing. The amount of accrued interest would have to be computed using compound interest rates, rather than simple interest rates, as at present. This reduces the amount of interest which can be deducted by the purchasers in the early years, and increases the overall percentage of the total debt which is deemed to represent interest. This increase in overall interest correspondingly lowers the total amount allocated to principal, which amount will be included in the buyer's basis for computing depreciation deductions. Thus, a purchaser's deductions for *both* depreciation and interest in the initial years of ownership will be reduced, considerably lessening the tax incentives for new investors to contribute needed capital to deteriorating low income housing projects.

For all the reasons stated above, it is vitally important that an exemption from this deferred payment proposal be granted for low and moderate income housing. A suggested definition of low and moderate income housing is described at the end of this statement.

B. Revenue impact of low income housing exemption

The Coalition has estimated that, taking a very optimistic view of the volume of resyndication of low and moderate income housing which will occur on a per annum basis, the total amount of additional debt as purchase money notes on which interest could accrue would be approximately $200–$300 million per annum. At an average interest rate of approximately $20–$30 million. Assuming that this annual interest is all currently deductible by 50 percent bracket taxpayers, this would mean an annual revenue loss of about $10–$15 million. Thus, even on a "worst case" analysis, out of the $2.5 billion of estimated revenue gain involved in this accounting reform, it is unlikely that an exemption for low and moderate income housing would result in reducing such gain by more than $10–$15 million per annum.

Moreover, this figure for revnue loss does not take into account the revenue gain when the seller in the resyndication process pays tax on the profit involved in his sale. Thus, the net revenue loss for an exemption for these transfer of low and moderate income housing is actually less than the gross revenue loss estimated above. A recent analysis indicates that resyndication of existing apartment buildings to take advantage of the depreciation provisions of the 1981 Tax Act will have little or no impact on federal tax revenues. Attached as Exhibit C is a copy of an article published on June 6, 1983, by BNA's Housing and Development Reporter which summarizes that analysis, prepared by David A. Smith of Boston Financial Technology Group, Inc.

Of equal importance is the revenue impact to the Federal Government if there are foreclosures of deteriorating properties. Currently, in the HUD-insured portfolio, there are 1,750,000 units with a total Insurance of Force of $35,900,000. Approximately 10.7% of that current portfolio is already either HUD-owned or HUD-held. Without a revitalization program, more and more units can be expected to be assigned to HUD. Reports indicate that, as of September 30, 1983, of the 256 projects, or approximately 29,000 units in the HUD-owned category, the loss to the Federal Government ranges from 70-87% of the original mortgage insurance amount per unit. This amounts to a loss to the insurance fund of approximately $17,500–$21,750, on a per unit basis. Alternatively, the loss to the Federal Government in utilizing federal tax incentives to raise private capital, and in turn to protect the insurance fund as well as maintain and upgrade the existing stock, is only approximately $5,000 per unit. This, results in a saving of federal revenue of $12,500–$16,570 per unit. The analysis supporting these figures is attached as Exhibit D. This revenue analysis does not, of course, even consider the potential losses to state governments which likewise insurance and finance low income housing projects.

III. PROPOSAL REGARDING RELATED PARTIES

Under this proposal, partnerships would be required to defer deductions for accrued interest and expenses owed to a "related" taxpayer until actually paid. The definition of "related" parties would be expanded to include partners and other partnerships with even and insignificant amount of common ownership interest.

Impact on low and moderate income housing

This related party proposal will not have any practical effect on transfers of property which are subject to the proposal described above on deferred payments. This is because the deferred payment proposal would automatically put the seller of property on an accrual basis and force the seller to include the accrued interest as taxable income. In this case the buying partnership would not be disallowed from deducting interest even if the seller is a partner, and thus a "related party."

However, it is vitally important that if the exemption for low income housing is granted from the deferred payment proposal above, a similar exemption be granted from the related party proposal.

The related party proposal would prevent new partnerships purchasing low income housing projects from keeping the old general partner who was an owner/manager of the property as a general partner of the new partnership. This is directly contrary to HUD's normal preference in its review and approval of these transfers. If these persons are retained as general partners of the new partnership, the HUD administrative procedure is far less costly, time consuming and far less complicated. However, if the old owner/managers are not included in the new partnership, HUD must review and evaluate the qualifications of the new owner/managers more thoroughly to ensure that they will be as qualified, and HUD imposes other additional costs on the transfer.

HUD's administrative treatment for projects which retain existing owner/manager, recognizes that in the last 15 years a new expertise has arisen in those housing developers which manage low income housing. Because the problems of managing low income housing are special, it is important to preserve this expertise at the same time that the existing low income housing stock is revitalized.

IV. PROPOSAL REGARDING ACRS RECOVERY PERIOD

A proposal has been circulated that would extend the real property cost recovery period from 15 to 20 years for used structures. This proposal would not only compound the problems between real estate and other investments but would create additional distortions among real property investment decisions. The impact would be particularly harsh on rental and low income housing as well as small businesses since it would reduce the value of property currently held. The proposal would substantially reduce the incentive to invest fresh capital in order to rehabilitate, modernize, and in some cases, prevent defaults on, older HUD properties.

V. EXTENSION OF SECTION 167 (K)

Until it expired on December 31, 1983, Section 167(k) was the principal means whereby rehabilitation of low income housing was encouraged. This provision allows a 5-year write-off of rehabilitation expenditures of up to $20,000 per dwelling unit. This provision has been a tremendous help in the preservation of our existing housing stock, and should be extended by Congress as proposed in bills already introduced, H.R. 4227 and S. 2089.

Conclusion

In summary, the Coalition for Low and Moderate Income Housing and the National Leased Housing Association believe that the present tax incentives directed at the maintenance and rehabilition of multi-family rental housing for individuals, principally elderly, and families of low and moderate income are vital to that process and, indeed, are the only such incentives left, now that most direct subsidies have been eliminated.

Morever, we agree with HUD that these tax incentives not only do the job, but, in the long run, the economic benefits of them accrue to the renters, and preserve our nation's diminishing housing stock. In addition, as Mr. David Smith has demonstrated, these resyndications are at little or no cost to the Treasury.

Accordingly, Congress should explicitly exempt low income housing from the proposals regarding deferred payments, related parties and any lengthened ACRS periods.

In addition Congress should extend the provisions of Section 167(k) to encourage rehabilition of low income housing.

[Exhibit A]

Recommended Definition of Low-Income Housing

In prior meetings with Congressional staff it was recommended that the definition of low and moderate income housing should incorporate the definition of low income housing already in the Internal Revenue Code. There are, however, two separate definitions of low income housing in the Code.

The older definition, contained in Section 1250(a)(1)(B), is based on the primary federal and state housing assistance programs in existence at the time the section language was enacted. The newer definition, contained in Section 103(b)(4), is based on a tenant income test and is used for purposes of determining a housing project's eligibility for tax-exempt bonds.

The two definitions do overlap to some extent but they are not co-extensive. Therefore, both definitions are incorporated in the proposed language defining low income housing.

In addition, language now needs to be added to the Code to include housing constructed or rehabilitated under the new HUD rental housing program enacted by Congress last year in the 1983 Housing and Urban-Rural Recovery Act. This Act provides grants for new and rehabilitated low income housing under provisions of a new Section 17 of the United States Housing Act of 1937. A summary of this new program is attached hereto.

We must stress here that this new housing program was enacted by Congress in 1983 with the assumption that all existing tax incentives would remain in place with respect to low and moderate income housing.

Based on the above considerations, we would recommend that the exemptions for low income housing include the following types of housing:

(i) property described in clause (i), (ii), (iii), or (iv) of Section 1250(a)(1)(B) of the Internal Revenue Code;

(ii) residential rental property described in Section 103(b)(4) of the Internal Revenue Code; and

(iii) residential rental property construction or rehabilitation of which is assisted by either (a) a rental rehabilitation grant made pursuant to Section 17(c) of the United States Housing Act of 1937, or (b) a development grant for new construction or substantial rehabilitation pursuant to Section 17(d) of the United States Housing Act of 1937.

[Exhibit B]

Federal Tax Incentives and Rental Housing, December 1982

EXECUTIVE SUMMARY

Purpose

The condition of the rental housing market has been the subject of considerable debate during the past few years. Concern has been expressed over a perceived shortage of middle-income rental housing, and the erosion of Federal income tax benefits has been cited as a contributing factor in the decline in unsubsidized rental housing investment. This erosion in the tax advantages accorded to rental housing has been due, in part, to the limitations placed on real estate tax shelters in the various tax reform acts passed during the last two decades. Therefore, the report of the House Committee on Banking, Finance and Urban Affairs accompanying the Housing and Community Development Act of 1983 instructed the Secretary to "conduct a study of the impact of Federal taxation law on rental housing, which shall at least include the impact of Federal tax laws with respect to: (1) the production of new middle-income rental housing; (2) the maintenance and rehabilitation of existing rental housing; (3) the conversion of existing rental housing to condominium or other uses; and (4) tenants residing in rental housing or prospective tenants of rental housing." This report also addresses the potential impact of the Economic Recovery Tax Act of 1981 on rental housing investment.

Organization and outline

This report begins with a description of Federal law incentives and rental housing, and the institutional setting underlying rental housing production: the rental housing industry and the principal participants in the industry. The report specifies and describes in detail the Federal tax incentives related to rental housing. This is followed by a description and summary of the major changes in the real estate investment portions of the Economic Recovery Tax Act of 1981 (ERTA).

The next section considers the effects over time of incentives created by the Internal Revenue Code (IRC) on decisions by investors and owners that relate to the production of new rental housing, the maintenance and conversion of the existing stock, and ultimately, to rents charged to tenants. In addition, it considers whether ERTA has restored the tax advantages to rental housing that have been eroded over the past several years. This section addresses the specific issues set forth in the report of the House Committee on Banking, Finance and Urban Affairs.

The impact of Federal tax laws on the production of new rental housing

Federal tax policies have been a major factor in the past in allocating capital investment toward the residential sector. Tax incentives were at least partially responsible for the development of the institutional vehicles for capital accumulation and investment in real estate during the 1970's. For example, the securities industry became a major participant in rental housing through its underwriting and marketing of limited partnership participations and stock offerings.

An analysis of rental housing incentives estimated that the present value to investors in new housing of the pre-1981 residential rental-specific tax incentives was between 10 and 15 percent of the value of a property, not including the longer-term effects of additional capital flows. As a result, an investor in the 50 percent marginal tax bracket would be willing to bid 10 to 15 percent higher for a rental property because of the tax incentives. The present value of the rental-specific tax benefits was increased by ERTA by approximately 9 percent for new buildings and 7 percent for existing buildings for investors in the 50 percent marginal tax bracket.

The impact of Federal tax laws on the maintenance and rehabilitation of existing rental housing

The pre-1981 tax laws favored investment in new housing over existing housing and owner-occupancy over rental-occupancy. Analysis suggests that the pre-1981 tax laws may have led to a reduced demand for existing rental housing. Such reduced demand may have increased the rate of economic depreciation of existing rental housing units and was probably one of the factors leading to an increased level of abandonment and demolition of older existing units in the early 1970's.

The 1981 tax law greatly reduces the previous large capital recovery differentials between new and existing rental housing. It encourages a succession of owners for a rental housing property to initiate a new depreciation cycle every 15 years. This could result in a reduction of economic depreciation and longer economic life for existing rental housing units. Longer economic life may result in decreases in housing abandonment and demolition, and retention of more older units in the inventory.

For three reasons, retention of older units in the inventory is not likely to lead to a reduction in the overall quality of the rental housing inventory. First, tax benefits to owners would be swamped by economic losses if succeeding owners permitted their buildings to run down to the point where they cease to be competitive. Second, a reduced rate of inflation can be expected to modify, at least to some extent, the inflation-related view of owner-occupied houses as investment vehicles. An increased demand for rental housing presumably will provide more income to owners for improved maintenance. Third, the 1981 law, in equalizing the depreciation treatment of existing buildings and new buildings, substantially increases the tax incentives for rental housing rehabilitation.

The impact of Federal tax laws on the conversion of existing rental housing to condominium or other uses

The condominium conversion phenomenon was fueled by the strong demand for homeownership that resulted from the decline in real after-tax homeownership costs in the 1970's. Other factors contributing to the conversion trend included lower profitability of multifamily rental housing ownership due to a lag of rents behind increases in operating and maintenance costs and a proliferation of rent control measures or consideration of such measures by local governments.

The factors underlying the condominium conversion trend may now have changed. ERTA has increased the tax benefits for owners and investors in rental housing. As indicated above, a lowered rate of inflation may reduce the tendency by many people to consider owner-occupied houses as investment vehicles. Apartment vacancies have begun to come down and the market is once again permitting rents to keep pace with inflation. Thus, in addition to the condominium conversion controls which many communities have adopted, conversions may be more limited because of changing market conditions.

The impact of Federal tax laws on tenants residing in rental housing or prospective tenants of rental housing

Given the competitive nature of the rental housing market, it is likely that most of the benefits of rental-specific tax provisions accrue to renters. Owners of rental property may benefit by themselves in the short run from a favorable change in rental tax provisions. However, an enhanced rate of return will attract more investment and lead to lower rents than would be obtained in the absence of the favorable change. This may be the scenario resulting from the 1981 tax law as increased rates of return attract additional investment to rental housing. Since renters have lower incomes than other households, tax benefits that lead to decreases in rents tend to be progressive in nature.

The potential impact of ERTA on rental housing investment

The 1969 and 1976 rental housing tax provisions reduced the rate of return to rental housing investment and were probably at least partially responsible for a flow of capital investment away from the rental housing sector. The rental housing tax provisions of ERTA have increased the rates of return to rental housing investment.

While ERTA has restored to rental housing investment tax incentives that have been eroded over the past several years, it has also increased tax incentives for investment in commercial buildings and plant and equipment. In some cases the tax incentives provided to commercial and industrial properties under ERTA were greater differentially than those provided to rental housing. The revised tax code still favors investment in rental housing over nonresidential properties but less so than before. Because of such countervailing forces, the overall potential impact of ERTA on investment in rental housing is unclear.

The pre-1981 tax provisions, favoring new over existing rental housing and owner-occupancy over rental-occupancy, may have contributed to an increase in the quality of the rental stock. While this effect could reverse under ERTA, other factors may offset such a reversal.

The major factors contributing to the condominium conversion phenomenon may be receding in the 1980's. The favorable rental housing investment provisions in the 1981 tax law and a reduced rate of inflation could be responsible for the change.

It is likely that most of the benefits to owners and investors under ERTA will accrue to tenants in the form of lower rents than would be the case without ERTA.

EXHIBIT C

HOUSING & DEVELOPMENT REPORTER

Volume 11, Number 2 THE BUREAU OF NATIONAL AFFAIRS, INC. June 6, 1983

BUSINESS AND FINANCE

ANALYSIS SHOWS RESYNDICATIONS WILL HAVE LITTLE IMPACT ON FEDERAL REVENUES

The resyndication of existing apartment buildings to take advantage of the depreciation provisions of the 1981 tax act will have little or no impact on federal tax revenues, according to an analysis by a Boston-based syndicator.

The analysis by David A. Smith of Boston Financial Technology Group, Inc. shows that here will be virtually no additional net tax expenditure for a resyndication without secondary financing. Even with secondary financing, the study says, the cost to the federal government will be relatively low, compared with alternatives to resyndication. In addition, Smith says, resyndication provides capital to upgrade projects and generally brings improved management.

The model used by Smith in his analysis is a 200-unit Section 236 project which went to final endorsement in 1972, with an original cost (debt plus equity) of $17,500 per unit, and which was resyndicated in January 1984 for values ranging from $16,250 to $25,000 per unit. Smith used a federal discount rate of 13 percent in his calculations. He also included certain mortality assumptions on the rate at which original partners would die, resulting in a step-up in basis and forgiveness of gain if the project weren't resyndicated.

Calculating Costs

In computing the net cost to the government of a resyndication, Smith notes, the tax deductions available to the new investors must be offset by the future deductions available to the original owners, in the absence of resyndication, and by the taxes paid by the original owners on the sales proceeds. (Technically, as Smith points out, the amount used in the calculation for taxes is the increased present value of taxes paid now over taxes that would be paid on the eventual sale of the project, if it weren't resyndicated.)

Smith uses three scenarios: a decline in project value to $16,250 per unit at the time of resyndication, with no secondary financing; an increase in value to $22,500, with some secondary financing; and an increase to $25,000, with a larger amount of secondary financing.

Under the first scenario, the analysis shows a net present value of the federal tax expenditure associated with the resyndication of $214 per unit, or 3 percent of the $1.285 million in capital raised through the resyndication. In this case, the taxes paid by the seller offset virtually all of the additional deductions available to the buyers. In the second scenario, the net tax expenditure is $2,068 per unit, or 32 percent of the capital raised, and in the third, the tax expenditure is $2,804 or 44 percent of capital raised.

Even the higher amounts, the report says, are less than one year's Section 8 contract and about half the cost of a mortgage assignment. Therefore, it says, if HUD might have to provide Section 8 assistance to a project or take an assignment, the government would be better off financially with a resyndication.

EXHIBIT D

IMPACT ON TREASURY OF DEDUCTIBILITY OF ACCRUED INTEREST

	HUD Held Property		Troubled Property		Healthy Property	
I. WITH ACCRUED INTEREST						
Syndication dollars (per unit)						
HUD arrearages and fees	$ 3,250		$ 1,270		$ 240	
Property improvements	(Note 1)		1,000		1,000	
Operating deficits & reserves	1,400		900		N/A	
Gross dollars to sellers	4,330	alternative to foreclosure and no cash to pay tax	4,700	alternative to foreclosure and no cash to pay tax	5,000	incentive to sell and maintain high quality of care
Sellers taxes paid	$ 4,330		$ 3,875		$ 3,100	
Revenue lost from all tax benefits (including depreciation and accrued interest)(2)	(9,130)		(9,500)		(7,400)	
Net Treasury loss	($ 4,800)		($ 5,625)		($ 4,300)	
Treasury loss from foreclosure(3)	18,100		14,500		13,800	
NET TREASURY BENEFIT	$13,300		$ 8,875		$ 9,500	
Accrued interest as percent of loss	31%		20%		27%	
II. WITHOUT ACCRUED INTEREST						
Syndication dollars (per unit)						
HUD arrearages and fees	$ 3,250		$ 1,270		$ 240	
Property improvements	(Note 1)		1,000		1,000	
Operating deficits & reserves(4)	700		650		N/A	
Gross dollars to sellers Total	2,140	insufficient cash generated to pay taxes	3,375	insufficient cash generated to pay taxes	3,300	marginal after tax benefit
Sellers taxes due	$ 3,900		$ 3,600		$ 2,750	

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1. Completed during assignment period.
2. Present value at 14% over 8-year holding period. Assumes 50% taxpayer.
3. Recovery rate of 30%. Does not include additional subsidy requirement on foreclosed subsidized property.
4. Ratably reduced from Example I.

Mr. **Pease.** Thank you, Mr. Smith.

Are there questions from members? Mr. Rangel.

Mr. **Rangel.** Mr. Chairman, I apologize to this panel for being late, but I was advised that your testimony would be seeking continuation of legislation that would encourage the construction and rehabilitation of low and moderate income housing. As most of you know, I think this is a terrible way of providing shelter for those who need it, but I guess the next worst thing is the fact that we have an administration that is doing absolutely nothing to provide shelter.

Having said that, the administration has indicated that while it has this proposal that would eliminate the program completely, they are willing to discuss ways in which abuses could be curtailed, and in which certain types of multifamily housing could continue under the present type of laws or the present type of tax incentives.

So, while I have not had the benefit of your testimony, I do hope that you would have your staffs to get in touch with the staffs of the Ways and Means Committee as well as my Subcommittee on Oversight and Investigations, to see whether there is a way of adopting a proposal that would be acceptable to the administration. I hope that something can be worked out in this area. I thank you, Mr. Chairman, for recognizing me.

Mr. **Smith.** Mr. Rangel, we are in the process of preparing proposals such as you suggest for your staff, and hopefully we can come up with the kinds of answers you suggest.

Mr. **Simons.** Mr. Rangel, likewise, we go over each of the proposals of the administration, finding some constructive and some negative, and making recommendations for modification.

I would just like, Mr. Chairman, with your permission to address the question which I have heard argued here, an exemption for low-income housing from the original issue discount rules. My position is very clear that all multifamily housing needs this type of exemption.

I think Mr. Rangel was here in 1980 when I discussed tax exempt financing for multifamily housing. If we start creating exceptions in rental housing only for the low income, what you are doing is having a supply side from the bottom up.

One of the big problems we found in the last administration in trying to continue to have enough rental housing stock to keep the pressure off rents, and to give everybody the opportunity to rent, if they wanted to, at a reasonable price, was one to maintain enough supply. If the provisions that you are now talking about on the original issued discount are limited to low-income housing, better housing will have no other choice but to look to condominium conversion in order to get out from under the restrictions they face.

I would suggest that the conversions which took place in the late 1970's, and impaired the supply of rental housing severely, rendered hardship on all people who wanted to rent. In looking at the supply of rental housing, you must stimulate the entire gamut rather than just one area, and provide for the preservation of the entire gamut because, as you take stock out, you hurt people down at the bottom more than you hurt people any other place.

Mr. **Rangel.** Mr. Chairman.

You say that there should be no consideration of income as it relates to subsidy, direct or otherwise?

Mr. SIMONS. No, I am not discussing subsidy.

Mr. RANGEL. I am talking about the Tax Code, which some people interpret as a kind of subsidy.

Mr. SIMONS. I think the subsidy which was enunciated very clearly by the committee and by the Congress before was to give use of the Tax Code to all multifamily housing regardless of income level. Certain preferences were given to low-income housing.

Mr. RANGEL. OK, I understand that that is your position, but it is a very difficult one that comes at a time when you have a $200 billion deficit to fly; that regardless of one's ability to pay, we should give the same type of tax advantage.

Mr. GRADY. Mr. Rangel, our staff would also be glad to work with members of the staff of this committee and your staff in discussing these issues.

On this last point, if I may, that you brought about, I understand the problems and particularly in view of the deficit. I wholeheartedly support Mr. Simons' position, but I would suggest that if it is not possible to do this, at least for the production of new housing, we use the same kind of 20-percent exception which is available for tax exempt financing which would increase the supply of low-income housing, while at the same time increasing the supply of rental housing throughout the country.

Mr. PEASE. Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman.

I want to thank the panel. I know we all have the same aspirations for housing for everyone, but we have different routes that we take sometimes.

I would like to ask, and anyone can respond who wishes, in areas that have rent control laws, do you find rent control an impediment to building rental units or rental housing?

Mr. SIMONS. If I may answer that, Mr. Duncan. I don't think there is any question that rent control acts as an impediment to the creation of new housing. Lenders are concerned about what is going to happen with the administration of the rents, which are the income stream to that building.

It has been a problem and it continues to be a problem in certain areas where the administration of that rent control is not done is the proper fashion. That is something beyond the control of Congress and something beyond the control of everybody sitting here, how does each community administer its own rent control laws.

I know that when I served as FHA Commissioner, I had to preempt in number of communities because those laws were not being administered with regard to what the economic needs of that building were, and there was no program designed for that building which was to serve low-income people.

Mr. GRADY. Mr. Duncan, I certainly support Mr. Simons' position on this. It is particularly true in areas of this country where costs are extremely high. We find that it is necessary at the initial completion of the project to defer some of the costs, and we expect that eventually the rents will catch up with the costs that we have to have on rental projects.

Mr. **Duncan**. Is there any member of the panel that disagrees with the two statements just made?

[No response.]

Mr. **Duncan**. Thank you.

Thank you, Mr. Chairman.

Mr. **Pease**. Mr. Moore.

Mr. **Moore**. Mr. Chairman, I would like to ask the panelists, and I certainly thank them for their testimony this afternoon, if any one of you or any group of you have any kind of analysis regarding the value of some tax proposals that are being proposed by the administration to the building of multifamily housing units compared to the value of some other kind of assistance, either HUD, low-cost loans, or direct subsidies, or rent subsidies, or whatever. Do you have any kind of analysis for us? Does anybody have that?

Mr. **Grady**. Mr. Moore, there was a HUD study done in 1982 which might be helpful, because that was done looking at the ACRS provisions of the 1981 act, and it did point out that the incentives created in that act had benefits not only to the owners but to the consumers, that there was a reduction in rent as result of that act.

Mr. **Moore**. That is not what I am talking about. We have been presented before with comments from people saying that the cost of the tax subsidy doesn't produce the same amount of good as a direct subsidy in another way. That is my question.

The first speaker indicated that the housing funds from HUD has been cut back. Did those HUD funds produce more housing units than the cost of a certain tax shelter that involves some housing?

Mr. **Smith**. Mr. Moore, unfortunately, the direct subsidies to which you refer have been cut very, very substantially.

Mr. **Moore**. That is not my question.

Mr. **Smith**. The only thing left are the tax incentives. It is clear that if those direct subsidies were still in effect, it could and might be a more efficient way of providing subsidies for low and moderate income housing.

Mr. **Moore**. That is what I am trying to get at, the most efficient way to get at the problem.

Mr. **Smith**. That is quite possible. Unfortunately, that is not the situation today.

Mr. **Moore**. You phrased the question better than I did. Do any of you have any information, or any figures, computations on the efficiency of these tax expenditures, subsidies, shelters, whatever you call them?

Mr. **Lane**. Mr. Moore, let me say that the Congressional Budget Office did a very extensive study on that issue in 1976 or 1977. I know that the staff of the Joint Tax Committee have copies of that, and it addresses that very point.

Mr. Smith is right, the options don't exist, but in terms of which are more efficient, CBO has done that at great length, and that is obviously available.

Mr. **Grady**. Mr. Moore, we were trying to find, and we don't have the actual figures to provide at this time, but if we may, we would like to supply them to you and your committee as soon as we pull them together. Studies have been made by HUD and others. Also we have made some studies at NAHB, which we would like to supply to you.

Mr. MOORE. On the efficiency.

Mr. GRADY. Yes.

Mr. MOORE. That is just what I am looking for. Thank you.

Mr. RANGEL. Mr. Chairman, could I ask Mr. Simons, who is a New Yorker, who is against rent control with the facts that exist in New York and who recognizes that there is a limited supply of housing where there is an overwhelmingly large number of people seeking housing; would you let only supply and demand work its will without rent control?

Mr. SIMONS. Mr. Rangel, you and I have had this discussion, as you know.

Mr. RANGEL. Not publicly, though. [Laughter.]

Mr. SIMONS. But I have also had this discussion publicly, I think it was on the McNeil-Lehrer program. Rent control does not work. It is a chicken and egg situation. As long as you have the rent control, how are you going to get the housing produced.

Mr. RANGEL. I am going to assume that without rent control, we would find a lot of investors—people who want to make a profit—and that would expand the supply of housing.

I am asking you, though, in the situation that you and I know exists in the city of New York, where we have a large number of people that are seeking apartments in limited supply, would you allow just the landlords to charge the fair market value of any occupied apartment? I just would like to know, as a professional, how you would handle it?

Mr. SIMONS. Wiser heads than either one of us are trying to find ways to phase out the New York rent control law. They just passed part of the administration of it on to the State.

Mr. RANGEL. So what you are saying is in economic theory, it would make sense to get rid of rent control. But as a practical and political matter, we can't come up with a solution.

Mr. SIMONS. Mr. Rangel, I think we can come up with a solution. The problem is that no one wants to face the political reality of that solution.

Mr. RANGEL. What would you suggest to be one of the ways in which you can eliminate rent control?

Mr. SIMONS. Phasing out rent control in the city of New York, and providing the incentives for the building of apartments, and the rehabilitation and use of a lot of stock out there that has no incentive to be used now.

Mr. RANGEL. Would there be anything that you could do to protect those people who had limited income who are occupying the existing apartments?

Mr. SIMONS. Limited income people and people who are truly in need, I think, should be taken care of. But you know and I know that many people in New York City have the benefits without the need of the rent control law.

Mr. RANGEL. Your support means testing those who would receive the benefit of rent control?

Mr. SIMONS. I think New York has moved in that direction with regard to conversions and things like that.

Mr. RANGEL. Thank you, Mr. Chairman.

Mr. **Pease.** I would like to ask one question.

Is it basically the position of the members of the panel that there are no abuses in the use of limited partnerships for the production of multifamily housing, or that abuses exist, but they ought to be overlooked because of the social good that comes from increasing the stock of low-income housing?

Mr. **Simons.** I don't think that anybody—I know I personally am not advocating overlooking abuses—but we have just encouraged and enhanced the ability of the Treasury to deal with these abuses. I think last year's provisions were added to the act to increase enforcement and to make abuses less desirable to those who would seek to abuse the act.

Mr. **Lane.** I would like to say that there are some abuses in every field, including the one you just addressed. I think they are de minimis, and I urge you to pay special attention to the testimony, on the next panel, of Mr. Robert Stanger, who has statistically analyzed that in a very thorough way. He is the only person in the country who keeps these kinds of statistics, and I think his testimony will be very responsive to your question.

Mr. **Aronsohn.** Mr. Pease, I would like to comment. In my years as a tax lawyer, I have seen an abuse or two, but I don't think that the major abuses in the tax law relate to limited partnerships as such. A limited partnership is simply a form of business organization which does provide the ability to spread economic and tax benefits and risk among various individuals. It is the underlying transaction that is either abusive or not, not the form of organization.

Mr. **Pease.** So it would be all right, in your view, to treat limited partnerships as corporations, because corporations are able to share the risk and perform the same functions as limited partnerships, are they not?

Mr. **Aronsohn.** I think you have to come to grips with some very basic notions of what you want your tax policy to be with respect to American business. We have traditionally had both the corporate form of business activity, and the individual form of business activity. We have let our taxpayers choose which form they wish to engage in.

Corporations have some substantial business advantages over partnerships or sole proprietorships. We could go to a totally different system. A couple of years ago, we discussed integrating the corporate tax which would have been a reverse movement away from separate corporate taxation into single, rather than dual, level of taxation. I think probably there is more to be said for moving in that direction than moving in the other.

Mr. **Fass.** Also, the limited partnership is a vehicle where the smaller investor can pool his resources and get the benefits. If you said that limited partnerships didn't exist under the law and would be taxed as corporations, or large limited partnerships, the only people who would get the benefits of direct investment of real estate would be the people who could afford to do it. With respect to a general partnership, with a tendency in common, and demand out there on the street to the ones are guardians of substantial capital in the public arena, would be out in the cold.

Mr. PEASE. I am not interested in debating you, I am seeking information. Why could not a corporation be organized to perform the same purposes that limited partnerships do now? Obviously, the corporation could sell shares of stock to the same broad range of the public as a limited partnership can.

Mr. FASS. Mr. Chairman, one of the elements of a return in the real estate investment is the tax incentives. If you had a corporation, there is double taxation that would remain in the corporate level. Wall Street, as far as I can remember, has never recognized the asset value attributable to real estate companies. They have never traded in multiples similar to high technology companies. It hasn't been the greatest place to raise money for venture capital in real estate. The syndication process has. That is where a substantial amount of the equity to build the housing stock in this country has come from in the last 4 or 5 years.

Mr. PEASE. Well, that is helpful. That is what I am trying to understand.

So it is the tax advantages of a limited partnership which make it suitable, whereas the corporate structure is not.

Mr. FASS. That is correct.

Mr. LANE. Sir, what is happening is they are trading the tax advantages, and when we talk tax advantages here, Mr. Chairman, we mean the ones which Congress has enacted. Those tax advantages are being exchanged by developers and others for capital, equity capital put in by large numbers of people that under our present tax laws cannot be done in the corporate form.

Mr. PEASE. Is there any advantage to a person earning $25,000 a year to buy a limited partnership participation?

Mr. FASS. I think Mr. Stanger would support it, but we have clients who have syndicated real estate. The average investor in these large public programs puts about $8,000 in. It is part of his total financial plan.

Mr. PEASE. What would the average income of the average investor be?

Mr. FASS. I think the minimum suitability for most of the transactions is something like a $30,000 income or $30,000 net worth, but it is a part of his overall investment philosophy. He may be investing in real estate, he may be investing in oil and gas. He might have money in Treasury bills. It is just part of the financial plan, and it is not a tax shelter or abusive tax shelter. It just gives him incentives, as Mr. Lane said, that Congress has enacted.

Mr. LANE. These are basically income oriented partnerships, and again I would urge you—Mr. Stanger is really going to cover this point very thoroughly.

Mr. PEASE. Well, we still have a number of witnesses, and I appreciate your answers.

I would like to thank all the members of the panel for being with us this afternoon. You have been very helpful.

And now we will call the next panel involving Mr. Szymanski, Mr. Bennett, Mr. Stanger and Mr. Moses.

Our first witness will be Mr. John Szymanski with the International Council of Shopping Centers.

STATEMENT OF JOHN J. SZYMANSKI, MEMBER, GOVERNMENT AFFAIRS COMMITTEE, INTERNATIONAL COUNCIL OF SHOPPING CENTERS, AND VICE PRESIDENT AND DIRECTOR OF TAXES, THE ROUSE CO., COLUMBIA, MD., ACCOMPANIED BY EDWARD C. MAEDER, COUNSEL

Mr. SZYMANSKI. Good afternoon. It is an honor to be here with you today.

My name is John Szymanski, and I am vice president and director of taxes of the Rouse Co. of Columbia, Md., a publicly traded real estate company engaged in the acquisition, development, and management of income producing properties. Some of our properties you probably are familiar with: Harbor Place in Baltimore and Market Place in Boston.

I am here today as a member of the government affairs committee of ICSC, and I am presenting this testimony on behalf of the members of ICSC. Also with me today is Edward C. Maeder of Winston & Strawn, ICSC's legal counsel. ICSC is the trade association of the shopping center industry. ICSC has approximately 10,000 members consisting of shopping center developers, owners, operators, tenants, lenders, and related enterprises. ICSC represents the majority of the 24,000 shopping centers in the United States as of the end of 1983. It is estimated that between 5.5 and 6.2 million people are regularly employed in shopping centers, and that several hundred thousand more are annually engaged in new construction of shopping centers.

ICSC understands that there may be problems involved in the use of the current partnership accounting and corporate rules, and that there are concerns about purely tax motivated transactions. We generally agree that real problems in these areas should be addressed by the Congress. ICSC supports reasonable efforts to remedy some of the problems regarding the use of limited partnerships and accounting rules. Accordingly, we do not oppose a number of the proposals advanced by the administration regarding tax law and accounting law changes for partnerships and corporations, if these proposals are modified or drafted so as not to interfere with legitimate, nontax motivated transactions.

In our written materials, we have detailed comments on each of these proposals. The modifications we believe that are necessary will insure that these provisions will accomplish their objectives without having adverse effects on legitimate business practices and capital formation in the shopping center industry.

Also, I would like to point out that the frequent changes in tax laws affecting real estate investments since 1976 have created a significant degree of uncertainty in the industry. When a real estate transaction is formulated today, the uncertainty of potential future tax law changes hangs heavily over the head of the real estate developer. A lack of certainty in the tax laws is counterproductive to the economy.

I would like first to address the proposed changes in ACRS provisions for structures. ICSC and the real estate industry in general strongly oppose any change in the ACRS recovery period for structures. In fact, we recently sent a letter to the House Ways and Means Committee and the Senate Finance Committee indicating our strong concerns with respect to this matter. Our opposition is based on a pressing need for more, not less, investment in structures and on the many adverse effects of discouraging such investment for all structures—for used structures and for nonowner occupied structures. In fact, the present ACRS provisions are already heavily biased in favor of investments in equipment and against structures. Any change in the treatment of structures under ACRS will only make this difference greater.

Several proposals which may be considered by the committee would adversely affect investments in real estate, including shopping centers. In meeting its concerns about perceived abuses, the committee should be careful not to adversely affect the capital formation in the real estate industry. By permitting deductions in the operation of real estate to pass through the partnership to the investors, tax policies intended to attract investment capital into real estate are made effective. There should not be any distinctions made between sectors of the real estate industry. As ICSC studies have determined, housing starts and shopping center development are directly correlated statistically.

I will now address our concerns with respect to several of the specific accounting and partnership proposals. In the area of like-kind exchanges of partnership interest, case law permits an exchange of partnership interest in one partnership for a partnership interest in another partnership to be made tax free under certain circumstances. The proposal alters the tax-free like-kind exchange treatment of partnerships by making such treatment unavailable for the exchange of partnership interests in different partnerships. Also, gain would be recognized generally on like-kind exchanges that were not completed within 90 days after the property was transferred or was relinquished.

We understand the question of transferability of limited partnership interest has been treated differently by different courts, and there is great uncertainty in that area. However, we believe that the basic thrust of this proposal is, or should be, to deal with the tax free exchange of limited partnership interests, and that general partnership interests should be excluded from any changes in this area.

Next I will address the deferred-payments proposal. In this area—the major concern we have is related to the phantom income that would be required to be picked up on a sale of property by an investor. Thus, a cash-basis seller would be taxed on phantom or imputed income that the seller would not receive until some time in the future. In this case, what we are talking about is penalizing sellers for financing a sale of their property. This would have a serious negative impact on the transfer of property. Small business would be affected very adversely, as would sales of property that is in a troubled financial position.

The last thing I would like to cover is the area of earnings and profits. There is a proposal that would treat all distributions by domestic corporations as taxable income. We strongly recommend the continuation of the current law, which has been in existence for the past 70 years, to avoid the taxation of capital.

I thank you for giving us the opportunity to share information with you today. Our detailed comments on the other provisions is included in our written testimony.

Thank you.

[The prepared statement follows:]

STATEMENT OF JOHN J. SZYMANSKI, VICE PRESIDENT AND DIRECTOR OF TAXES, THE ROUSE CO., COLUMBIA, MD., ON BEHALF OF THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS

Summary

The International Council of Shopping Centers (ICSC) understands that there may be problems involving the use of the current partnership, corporate, and accounting rules and that there is concern about purely tax-motivated transactions. ICSC generally agrees that real problems in these areas should be addressed. ICSC supports reasonable efforts to remedy some of the problems regarding the use of limited partnerships and accounting rules. Accordingly, ICSC would not oppose a number of the proposals advanced by the Administration regarding tax law and accounting rule changes for partnerships and corporations, if these proposals are modified or drafted so as not to interfere with legitimate, non-tax motivated transactions.

In our detailed comments on these proposals, we indicate how we believe the Committee should modify the Administration proposals. These modifications are necessary to insure that in accomplishing the justified objectives of these proposals, adverse effects on legitimate business practices and on capital formation in the shopping center industry are minimized.

Statement

I. INTRODUCTION

My name is John J. Szymanski. I am Vice President and Director of Taxes of the Rouse Company of Columbia, Maryland, a publicly traded real estate company engaged in the acquisition, development and management of income-producing properties, both commercial and retail. I also am a member of the Government Affairs Committee and the Tax Subcommittee of the International Council of Shopping Centers (ICSC), and I am presenting this testimony on behalf of the members of ICSC.

KSCS is the trade association of the shopping center industry. ICSC has approximately 10,000 members consisting of shopping center developers, owners, operators, tenants, lenders and related enterprises. ICSC represents a majority of the 24,000 shopping centers in the United States in 1983.

A. The shopping center industry

It is estimated that between 5.5 and 6.2 million people are regularly employed in shopping centers and that several hundred thousand more are annually engaged in new construction. The rippling effect of shopping center development on employment in related businesses, including the manufacture of goods sold in the centers, display advertising, maintenance and cleaning, legal and accounting, is considerable.

It is estimated that in 1982 shopping centers accounted for 43 percent of total U.S. retail sales. By the beginning of the next decade (1990), the shopping center share will likely range between 50 percent and 55 percent. In current dollar value, U.S. shopping center retail sales reached a level of $462.5 billion in 1982.

B. Economic benefits of shopping center development

The extent of the contribution of shopping center development to the nation's productivity oftentimes is not fully appreciated. Many people think of productivity solely in terms of the process leading directly to the manufacture of goods. Others would broaden the concept to include the distribution of those goods to the loading docks of the nation's retail facilities—but not to the distribution of products to the ultimate customer. The fact is, of course, that retail facilities, as the final link in the chain of distribution, are an integral part of the productive process. Thus, to deny tax benefits to retailers but provide them to manufacturers or distributors is self-defeating and inconsistent since without adequate retail facilities there can be no expansion of the other links in the economic and production chain.

1. Employment

Shopping centers generate new jobs and secure existing jobs in a number of ways which represent tangible benefits to the community. Of course, the construction of a shopping center provides employment to all sectors of the building trades. In addition, ICSC has estimated that the tenants of shopping centers employ one full-time employee for every 400 to 500 square feet of gross leasable area space occupied by the tenants. Thus, a typical neighborhood or community shopping center of 175,000 square feet anchored by a soft goods store and a supermarket employs between 350 and 435 people. Moreover, many of these people, as recent entrants into the job market, would have been unemployable or marginally employable in industrial or office positions.

The increase in employment generated by shopping center development ripples through the local community as other businesses open or expand to provide services for the new employees. Each new opening or expansion creates, in turn, new jobs and additional revenues.

2. Tax revenues

The economic impact of shopping center development in local communities is clear. Sales taxes and real property taxes are two of the largest sources of state and local revenue attributable to shopping centers. Other direct contributions to local treasuries include business license revenues, franchise taxes, income taxes, and personal property taxes on such things as office and retail equipment and inventories.

C. Interdependence of the real estate industry

The various sectors of the real estate industry are strongly interrelated. For example, shopping center development and rehabilitation follow very closely new housing and job-related real estate such as office buildings, retail stores, and industrial facilities continually interact with one another. In a recent study conducted by the ICSC Research Department, the total square footage of annual U.S. shopping center construction starts (1970 to 1979) was correlated with annual U.S. housing starts (1969 to 1979). Results indicated that 95 percent of the variation in shopping center construction starts could be statistically "explained" by changes in the level of housing starts.

D. Small business development

The real estate industry is composed almost totally of small firms. Sixty percent of all construction firms and eighty percent of all real estate service firms have four or fewer employees. It is well established that the vast majority of all new jobs are created by small businesses such as these.

Unfortunately, the small business nature of the industry makes it unusually susceptible to changes in economic conditions, financial climate, the tax code and other public policies. During the past, those factors have combined to retard the growth rate of all areas of real estate.

It is important that the consequences of future tax policy changes on this important industry be carefully considered.

II. PROPOSALS AFFECTING SHOPPING CENTERS

A. Sources of proposals

Several proposals which may be considered by the Committee would adversely affect investment in real property, including shopping centers. These proposals would change the tax laws or accounting rules for partnerships or corporations investing in real estate. These proposals have been made by the Administration, Senator Dole, and others, and have been discussed in the Joint Committee on Taxation (JCT) staff pamphlet prepared for these hearings.

B. General comments

1. Needed investment in structures

In meeting its concerns about perceived abuses, the Committee should be careful not to affect adversely capital formation in the real estate industry. Prior to the enactment of the Economic Recovery Tax Act of 1981 (ERTA), there had been a long term insufficiency in real property investment. ERTA provided some incentives for such investment. However, the Congressional Research Service has stated that the present law is still biased against investment in structures. Any change in the tax law which would increase the effective tax rate on income from investments in structures would increase this bias, result in further misallocation of investment capital, and increase the resulting economic loss.

2. Appropriate use of limited partnerships

Commercial and multi-family residential real estate ownership generally involves resources far beyond those of an individual. For this reason, virtually all investment in such property is accomplished through partnerships or corporations. Limited partnerships are one of the preferred forms of ownership of real property because their business, legal and tax attributes are well matched to the characteristics of real estate investment.

In a typical real estate limited partnership, the investment is managed by a general partner that is a substantial, experienced organization which bears the liability for the enterprise. The general partner has authority to manage the investment. The investment capital is primarily contributed by a number of individuals who are shielded from liability in excess of their investment. The limited partnership mechanism makes available investments in large real estate projects to middle income persons by permitting a relatively modest minimum investment and shielding their liability beyond that investment while providing them with the right to inspect the partnership's books to protect their investment.

Another important characteristic of partnerships is that they permit the effective use of tax benefits by investors, and, thus, effectuate tax policies intended to encourage investment. By permitting deductions from the operation of real estate to pass through the partnership to the investors, tax policies intended to attract investment capital into real estate are made effective.

The members of ICSC invest in and manage shopping centers, assets with real economic substance and substantial economic and social benefits to their communities. Investments in shopping centers often are made through limited partnerships.

ICSC supports reasonable efforts to remedy some of the problems regarding the use of limited partnerships and accountiung rules.

However, Congress should be cautious in enacting such legislation in order to assure that legitimate and economically important uses of limited partnerships will not be impaired by measures intended to stop non-economic, tax-motivated transactions.

In this regard, we are concerned with the tone and some of the substance of some of the criticism and proposals in this area. Some of the analysis reflects a purely theoretical, overly simplistic view of the business practices that would be affected by the proposals. It often ignores the impact of the proposals on legitimate, non-tax motivated transactions. For this reason, some of the proposals go far beyond the perceived problem and would have far reaching, economically adverse effects not considered or discussed by those who propose them.

3. Partnership and corporation changes

ICSC would not oppose a number of the Administration's proposals regarding tax law and accounting rule changes for partnerships and corporations, if these proposals were modified and drafted so as not to interfere with legitimate business transactions. We understand that there may be problems in the use of some of these provisions, and agree that the Committee should deal specifically with these problems.

In our detailed comments, we indicate how we believe the Committee should modify the Administration proposals so that they accomplish their goals without having an adverse effect on legitimate business practices.

However, some of the proposals would create severe problems for many non-tax motivated business transactions. These proposals would discourage or deter many projects with substantial economic and social benefits. We oppose such proposals, including the proposal to tax phantom income in deferred interest transactions and the proposal to prohibit tax-free like-kind exchanges of general partnership interests.

C. Proposals to change partnership, corporate and accounting rules

Several of the proposals characterized as dealing with partnership, corporate, and accounting rules would affect real estate investments. The most important of these are as follows:

(1) partnership allocations and distributions;

(2) retroactive allocations of partnership taxable income and loss;
(3) treatment of property contributed to a partnership;
(4) like-kind exchanges of partnership interests;
(5) deferred payments of indebtedness;
(6) premature accrual of expenses;
(7) prepayments of expenses;
(8) related party transactions;
(9) distributions in liquidation of a corporation;
(10) earnings and profits of a corporation; and
(11) dividend distributions of appreciated property.

III. COMMENTS ON THE PROPOSED CHANGES IN THE TAX LAW REGARDING PARTNERSHIPS, CORPORATIONS, AND ACCOUNTING RULES

A. Introduction

These comments are addressed to the proposals changing certain partnership and accounting rules contained in the Fiscal Year 1985 Budget submitted by the Administration to Congress on February 1, 1984 (the "Administration proposals") and similar proposals circulated by Senator Dole on November 16, 1983 (the "1983 Dole proposals"). The comments also address two other proposals dealing with changes in the taxation of corporations that would have adverse effects on the formation of capital for many types of business and industrial ventures.

While no legislative language is available for any of the proposals at this time, these comments reflect the best understanding of the proposals that can be obtained from the available documents and discussions with those who prepared them.

B. Effective dates and grandfather clauses

The comments that follow discuss in detail the substantive impact of certain proposals. However, the date on which the proposals become effective also is of great importance. ICSC strongly urges that effective dates be selected that are prospective. They certainly should be no earlier than the date of enactment in order to be fair to all taxpayers and to give taxpayers time to modify pending business transactions. We believe that retroactive changes in the tax law are unconscionable and violate the standards of fairness and decency that should characterize the relationship between the government and its citizens.

The proposals also should contain "grandfather" clauses to protect transactions entered into pursuant to contracts which are binding on the taxpayer on the effective date and transactions pursuant to which properties have been acquired or construction, reconstruction or rehabilitation begun. A small number of transactions will inevitably be entered into shortly before the effective date, but the problems of curtailing existing legitimate business activity by imposing retroactive effective dates are far greater.

The recent practice of making tax law changes effective on the date they are proposed is particularly inappropriate for these provisions. Such action would either freeze the market, preventing what the Administration agrees are legitimate and productive transactions, or require people to guess as to what will be enacted and with what modifications and amendments. We submit that making the tax law a game of chance is not good policy.

C. Partnership allocations and distributions

1. Present law

Subject to certain limitations, partnerships may make separate and independent special allocations of various items of partnership income, gain, loss, deduction and credit.

2. Proposal

If a direct payment by the partnership for property or services would be chargeable to capital, distributions to a partner for such property or services would be treated the same as those made in a transaction between the partnership and one who is not a partner. Thus, those amounts would have to be capitalized. In addition, certain arrangements whereby a partner contributes property to a partnership and receives a contemporaneous distribution will be treated as a sale among partners or as a part sale/part contribution to the partnership.

3. Comments

We agree that abuses may occur when partnerships are structured so that payments which should be capitalized are disguised in order to be deducted as an allocation of income. So long as the definition of items which must be capitalized follows current law regarding guaranteed payment, we believe the Administration proposal is a reasonable solution to this potential abuse. We oppose, however, the 1983 Dole proposal prohibiting all item allocations because it is overly broad and places unnecessary and unreasonable burdens on legitimate business arrangements.

D. Retroactive allocations

1. Present law

Items of partnership taxable income attributable to that portion of the partnership's taxable year preceding a partner's entry into the partnership generally may not be retroactively allocated to him. However, deductible expenses incurred prior to a new partner's entry into a partnership can be assigned to a new partner by the partnership's use of the cash method of accounting and the deferral of the payment of the expenses until after the new partner's entry.

2. Proposal

Retroactive allocations of partnership taxable income and loss would be prevented in the case of a cash basis partnership and a tiered partnership arrangement.

3. Comments

This proposal attacks a customary business practice by denying to partners deductions for expenses which may have been paid with funds they contributed to a partnership, if the obligation to pay those expenses was incurred prior to the partners' date of entry. Investor limited partners are normally brought into a partnership for the development of real estate over a period of time within which the partnership is moving forward on various elements of its business. Obligations are undertaken during this period in the expectation that investor limited partners will provide the funds with which to meet those obligations. It is inconsistent with normal business practice to deny cash basis taxpayers the right to deduct expenses paid prior to their entry to the partnership, particularly when the economic structure of the partnership anticipated paying those expenses out of funds provided by the new investor.

In addition, the 1983 Dole proposal for computing allocations on a daily basis or on a strict prospective basis from the day a partner enters a partnership would place an unjustifiable administrative burden on the partnership. Many items, such as rental receipts, interest charges, ACRS depreciation under Code § 168 and the amortization of certain expenses relating to the beginning of a partnership's or corporation's business or acquisiton of assets, use monthly accounting periods. Thus, partnership accounting and management information systems could accommodate a change in the law which permitted the partnerships to allocate to partners admitted to the partnership in a particular month only those expenses and other items attributable to the month. Although such a change in the law would be unjustified and inappropriate, it at least would be technically workable.

E. Property contributed to a partnership

1. Present law

Property can be contributed to a partnership and the gain or loss from its sale, or the depreciation or depletion generated by it, shifted between the partners without regard to the standards that govern allocations of partership operating income or loss generally (such as substantial economic effect). Thus, the built-in loss on contributed property can be shifted from the contributing partner to the other partners. In addition, any depreciation or depletion from the property can be allocated to the partners regardless of their real economic interests in the partnership.

The character of property contributed to a partnership generally depends on the relationship of the property to the partnership business. Thus, assets that were ordinary income assets (inventory and unrealized receivables) in the ordinary income assets (inventory and unrealized receivables) in the hands of a partnership can become capital assets in the hands of a partnership.

2. Proposal

The rules relating to the allocation of depreciation, depletion, gains and losses on contibuted property would be changed. Under these rules, any built-in gain or loss from a sale of the property would have to be allocated to the contributing partner. Depreciation and depletion would be allocated to the contributing partner and the other partners in proportion to their interests in the partnership. Thus, the elective rule in present law to allocate gain or less and depreciation and depletion so as to take account precontribution appreciation or depreciation in the property would be made mandatory, with certain minor modifications.

Built-in losses on contributed capital assets would retain their character as capital losses for five years. Property that was inventory in the hands of a contributing taxpayer would retain its character as ordinary income property for five years in the hands of the partnership. Gain from unrealized receivables contributed by a partner would constitute ordinary income to the partnership.

3. Comments

Use of the partnership structure should not permit taxpayers to escape "dealer" status or change the tax treatment of a particular piece of property, and the gain or loss attributable thereto, simply by making a contribution of the property to a partnership. However, the prevention of such practices can be accomplished in a more equitable manner than that of the Administration or 1983 Dole proposals.

In accordance with the Administration proposal, "built-in" gains or losses on contributed capital assets should be allocated to the contributing partners and should retain their character in that partner's hands for five years. Further, gains or losses attributable to that property in the five years subsequent to contribution should be treated for tax purposes—with respect to the contribution partner—as if the contribution had not taken place. For the remaining partners, however, the tax treatment of the property should be the same as any other property of the partnership. Under this structure, the contributing partner cannot reap any tax benefit by virtue of having contributed the property to the partnership, but the partnership is not unfairly penalized simply because of the prepartnership tax status of a particular piece of property contributed to it.

F. Like-kind exchanges of partnership interests

1. Present law

Case law permits an exchange of a partnership interest in one partnership for a partnership interest in another partnership to be made tax-free under certain circumstances. (*Gulfstream Land and Development Co.*, 71 T.C. 587 (1979).

Also, case law permits tax-free deferred like-kind exchanges if completed within five years. Thus, for example, an owner of property can transfer it in exchange for the right to designate a piece of like-kind property to be given for his property. If the property is received within five years, the like-kind rules apply. (*Starker* v. *United States*, 602 F.2d 1341 (9th Cir. 1979)).

2. Proposal

Tax-free, like-kind exchange treatment would be unavailable for exchanges of partnerships interests in different partnerships. Also, gain would be recognized generally on like-kind exchanges that were not completed within 90 days after the property transferred is relinquished.

3. Comments

We understand that the question of the transferability of limited partnership interests has been treated differently by different courts and that there is uncertainty in the law regarding this question. While we understand the arguments on both sides, and might prefer a different answer, we believe that the basic thrust of this proposal is—or should be—to deal with the tax-free exchange of limited partnership interests.

However, the proposal goes well beyond this objective to preclude the exchange of general partnerships interests on a tax-free basis. Recent court decisions such as *Gulfstream Land and Development Corporation*, 71 T.CV. 580 (1979), have held that general partnership interests are sufficiently distinguishable from stocks, chooses, in action, etc., to be excluded from the parenthetical language under Section 1031 and therefore, should, be entitled to non-recognition treatment under certain circumstances. These holdings stand for the proposition that non-recognition treatment should be available for general partnerships, at least where the holder of the partnership interest is actively engaged in the partnership business as a general partner and the underlying assets of the partnership would qualify for Section 1031 treatment.

There are legitimate non-tax motivated reasons for such transfers that are currently allowed. For example, it may be necessary for business reasons for partners to rearrange their holdings of partnership interests and/or diversify their partnership interests due to circumstances that are clearly recognized in the non-taxable corporate reorganization provisions. In these circumstances, it is understood and agreed that partnership liabilities should be considered and boot computed as if the assets and liabilities were exchanged directly. Thus, partners would be able to qualify for Section 1031 treatment (see *Magneson,* 81 T.C. 47) after liquidating their partnership interests. To exclude these interests from qualifying under Section 1031 would be inequitable and inconsistent with the overall thrust of the current statutes.

In addition, the requirement for specific and immediate identification of the qualifying property contained in the 1983 Dole proposal will cause serious problems in many real estate transactions. In many transactions, the taxpayer may have every intention to use the designated property in an exchange, but is unable to do so for some reason. If these proposals are adopted, what happens if the negotiations for an identified property fall through? Also, how are substitutions of property treated if the requirement for a substitution is beyond the taxpayer's control? To avoid these problems, the proposal should be modified to provide that the property for which the exchange is to be made must be specifically designated within one year after the close of the taxable year.

With respect to deferred, non-simultaneous exchanges, we agree that the five years allowed under *Starker* v. *U.S.,* 602 F.2d 1341 (9th Cir. 1979), may be too long, but the three month period contained in the administration proposal generally will not be long enough to negotiate and close a real estate transaction.

G. Deferred payments

1. Present law

Unstated interest on deferred payments on the sale or exchange of property is allocated proportionally to payments (Section 483). The safe-harbor interest calculations are made on a simple rather than compound basis. The original issue discount rules generally do not apply to bonds or other indebtedness issued for property, or to obligations issued by an individual.

2. Proposal

Section 483 would be revised so that interest rates would differ depending on the maturity of the obligation and be adjusted every six months. Further, the safe-harbor interest computations would be made on a compound interest basis. The proposal also provides that imputed interest would be taken into account under the periodic inclusion rules of section 1232A (and the corresponding rule for deductions in sec. 163(e)). The maximum test rate for real estate transactions between related parties under present law would be retained. The exception to section 483 for sales of ordinary income property would be repealed. The capital asset limitation and the natural person exceptions to section 1232A would be repealed.

The scope of the original issue discount (OID) rules would be expanded to include the purchase or use of property or services for discount obligations where neither the property or services nor the obligations are publicly traded. This means that the seller of property on the installment basis would have to report as taxable income all interest accrued on the installment obligation (whether or not received), even if he is a cash basis taxpayer. In these cases, the amount of the interest which is deemed to accrue would be determined by reference to the interest rates under section 483. Exceptions to the expanded OID rules would be provided for transactions such as sales of farms by individuals or closely held businesses, sales of principal residences, and sales involving payments of $250,000 or less. For these excepted transactions, deductions for discount interest would not be allowed and discount income would not be recognized prior to the time of payment.

3. Comments

This proposal would have a severe and adverse effect on the sale and preservation of real property generally, and would have a particularly drastic impact on low-income housing. First, the proposals would require a cash basis seller to be taxed on "phantom" or imputed income which the seller would not actually receive until years in the future. Thus, sellers would be penalized for financing a sale of their property. This would have a serious negative impact on the transfer of property, especially during periods of high inflation and economic difficulty. In effect, this rule would arbitrarily force the cash basis taxpayer to be taxed on an accrual basis. As a result, economically troubled businesses might be prohibited under these provisions from negotiating the deferral of payments to creditors and suppliers who would be willing to assist such businesses in surviving periods of financial difficulty.

Also, in transfers of government-assisted housing, where cash flow is restricted and interest must be accrued rather than paid, sellers would not be able to receive enough cash to pay the taxes owing to their phantom income. As a result, the buyers of such housing would have a drastically reduced basis and no incentive to contribute the additional capital needed to maintain and preserve the building properly.

The second problem under the rule is the requirement that imputed interest be calculated on a compound basis rather than as simple interest. This proposal runs contrary to historic and customary practices in the U.S. real estate industry, as well as many state laws which required real estate interest calculations to be made on a basis of simple interest.

The rationale for this proposal is a highly theoretical economic analysis of deferred payment transactions. It ignores the enormous variety of transactions that occur in the real world, and forces everyone to conform to an economic model which may be at variance with legitimate business concerns.

It is appropriate for the Congress and the Administration to be concerned about abusive transactions in which interest is accrued that will never be paid and values are inflated artificially. However, abuses of this nature can and have been dealt with under the recently enhanced IRS enforcement and penalty procedures. If further action is necessary, the proposed rules should only be enacted if they include (1) a safe harbor which would apply if the purchaser of an obligation on an installment basis paid at least 50 percent of a market rate of interest of an annual basis and accrued the balance and (2) low-income housing transfers are exempted. This exemption is necessary because the cash flow with which to pay any portion of additional interest resulting from a second mortgage is not available.

H. Premature accrual

1. Present law

Under the accrual method, deductions are allowed (1) when all events have occurred which establish the fact of the liability giving rise to the deduction, and (2) the amount can be determined with reasonable accuracy.

2. Proposal

The "all events" test would be clarified to provide that no deduction would be allowed until economic performance occurs. For example, a deduction would be permitted when services are performed, when use of property occurs and, in the case of workmen's compensation or similar liability, when the liability is satisfied. An exception to this rule would be provided for cases in which economic performance will occur within one year after the end of the taxpayer's taxable year. Exceptions to this rule would be made for transactions to which other sections apply, for example, for the deduction allowable under section 166 (relating to bad debts). Also, the net operating loss carryback rules would be amended to allow losses to be carried back to the year in which the obligation generating the loss arose.

3. Comments

The Administration proposal would only restrict deductions where "economic performance" has not occurred. In this context, the performance of services and the forebearance of money owed should be considered "economic performance." Thus, payment may be accrued so long as the goods or services for which the payment was owed have been received or performed. If or understanding of economic performance is correct, we believe this is a reasonable approach.

I. Prepayments of expenses

1. Present law

Under the cash method of accounting, deductions are allowed for expenditures in the year paid. Prepaid interest is treated as paid in the period to which it is allocable (*i.e.,* cash basis taxpayers report interest as if they were on the accrual method).

2. Proposal

The deduction of prepaid expenses prior to the period to which the expenses are allocable would be prohibited to "syndicates" other than farming. The prohibition would apply to both cash and accrual taxpayers.

3. Comments

The prepayment of expenses has the potential for abuse. We would point out, however, that there are many instances of legitimate and customary business practices that provide for the prepayment of expenses for non-tax related reasons. For example most forms of insurance and many real estate taxes are paid once a year and in advance. Similarly, taxpayers may prepay expenses to simplify or minimize billing, bookkeeping, and other associated administrative costs for the payee as well as the taxpayer. Under current case law, as set forth in *Zaninovich* v. *Commissioner,* 16 F.2d 429 (9th Cir. 1950), prepayments of expenses for up to one year after the date of payment are currently deductible. We believe this is a reasonable and appropriate standard which eliminates the potential abuse of prepaying expenses many years in advance, but which does not impose costly and burdensome requirements on legitimate business transactions.

J. Related party transactions

1. Present law

An accrual-basis taxpayer is denied a deduction for certain accrued expenses owed to a related cash-basis taxpayer unless expense is paid within 2½ months after the close of the taxable year in which expense is accrued. Partners and partnerships, and controlled corporations, are generally not treated as related for this purpose.

2. Proposal

Taxpayers subject to this provision would be required to defer deductions for accrued interest and expenses owed to a "related" taxpayer until actually paid. The definition of "related" parties would be expanded to include partners, partnerships and controlled corporations regardless of the amount of common ownership interest.

3. Comments

It is essential that some form of a de minimis exception be provided for common partnership interests. We believe that a minimum ten percent ownership in capital or profits would be an appropriate de minimis rule. This minimum amount tracks the percentage used in the "anti-churning" provisions of section 168(e)(4) of the Internal Revenue Code for related parties.

There often are non-tax reasons, such as preserving the continuity of management, for allowing a minimum percentage of common ownership. Also, the ten percent minimum reduces the possibility that parties will become "related" inadvertently. For example, this would occur when one person purchased investment units in a new partnership which is the owner of property in which the person has, or even formerly had, an interest.

Moreover, in situations involving transfers of government assisted housing, old partnerships or persons owning the property and new partnerships purchasing the property will often be related for such non-tax reasons as the governmental regulatory agency preference for continuity of management. In addition, agency rules normally prohibit the new partnership from paying some or all of the interest on the purchase money notes currently, because HUD rent restrictions do not permit enough cash flow to pay the interest on a current basis. The adoption of the proposals without a de minimis rule would contradict HUD support for transfers which allow deteriorating projects to be refurbished in order to avoid costly government foreclosures.

K. Distribution in liquidation

1. Present law

Under section 337, except for recapture income, life inventory reserves and certain installment obligations, no gain is recognized to a corporation on a distribution of assets in complete liquidation of the corporation.

2. Proposal

Distributions to shareholders of all items constituting ordinary income assets to a liquidating corporation would result in the recognition of gain to the corporation.

3. Comments

This proposal would impose a double tax on the appreciation in value of corporate assets sold or distributed in a complete liquidation. This would effectively raise the capital gain tax on this element of gain from investment in corporate business from 20 percent to 42.4 percent.

This impact will be almost entirely on closely-held small and family businesses, because large, publicly-held companies seldom undergo complete liquidation. This is neither an efficient nor a fair tax increase, and ICSC recommends strongly against it.

Small and family businesses typically hold a wide range of business assets, including real estate from which their manufacturing or wholesale or retail business may be operated. Small and family companies also hold real estate which has been collected and developed over a long period of years and is leased to third parties. These small and family corporations have paid full corporate income tax on their earnings, often over several family generations. The assets likely have appreciated substantially in value over a long period of years, in large part as a result of inflationary gains. Also, small and family businesses may have developed patents, trademarks, trade secrets, a trade name, know-how, goodwill, or other intangible asset values which have appreciated greatly in value. This is a typical pattern in many of the high technology companies.

These corporations have operated their business based on certain fundamental assumptions as to our taxing system as it has operated for the last fifty years. As previously stated, they have paid a full corporate income tax on their regular taxable earnings, and a second shareholder level tax on any such earnings distributed as dividends. However, our system has not required them to pay a double tax on retained earnings reinvested in the business. Also, our tax system has provided that they would pay only a single capital gains tax on the appreciation in value of the underlying assets in their business upon selling or otherwise completely liquidating such business.

This proposal would impose a double tax on the appreciation in value of the underlying assets of a corporation, a gain which usually is largely an inflationary gain, and the effective tax rate would be increased from 20 percent to 42.4 percent.

In the short run, the result will be to encourage small and family corporations to merge their companies into large publicly-held companies in a tax-free exchange for the stock of the public company. Public companies with tax losses or with unused investment tax credits will seek to acquire such privately-held companies.

These substantial adverse effects far outweigh any possible benefits of the proposal.

L. Earnings and profits

1. Present law

Distributions by a corporation to its shareholders constitute dividends only to the extent of the corporation's earnings and profits. Distributions of corporate assets to shareholders in excess of current and accumulated earnings and profits reduce the shareholders' bases for their stock, and any excess over stock basis generally is treated as capital gain.

2. Proposal

All distributions by domestic corporations to their shareholders would receive ordinary income treatment.

3. Comments

We strongly urge the retention of the present earnings and profits concept under which the characterization of distributions as ordinary income is determined.

The earnings profits limitation on the characterization of distributions as ordinary income should not be repealed.

The limitation of ordinary income treatment of corporate distributions to situations where a corporation has earnings and profits has been a fundamental concept in the taxation of corporate distributions for 70 years. It implements the principle of taxing a corporate shareholder only on distributions out of corporate income, not on the return of his invested capital. This basic principle of taxation is valid and should continue to be observed.

The taxation of capital that would result from the adoption of the proposal would adversely affect capital formation and competition through the new entry of businesses. Often the creators of a small business such as a strip shopping center must put a substantial amount of equity into the new business because they cannot readily obtain financing. When the business has been established (often 5–10 years later), and financing is obtained, the original equity can be withdrawn tax free, as a dividend, for other uses. This proposal would tax at ordinary income tax rates this return of capital and would have a negative effect on the willingness of people to undertake business activity in the corporate form and on the free transfer of capital.

Many small businesses could be expected to respond to the enactment of this proposal by foregoing the protections of the corporate form and adopting the partnership form. This encouragement of the formation of partnerships rather than corporations is contrary to current IRS policy.

The repeal of the earnings and profits limitation was one of the proposals made by the Senate Finance Committee staff in its September 22, 1983, report on the reform and simplification of corporate taxation. The apparent abuses described in the staff report are specific deficiencies which can be corrected without eliminating the earnings and profits concept. None of those problems justifies such a fundamental change in tax policy. For example, one of the staff's examples is the corporation that borrows against the unrealized appreciation in its assets in order to distribute the proceeds when it has little or no earnings and profits. If this is a frequent problem, a simple amendment to section 312 can correct it. Another example—the distribution of debt obligations—is currently addressed by the income tax regulations. It would seem that any problems under the existing rules could be cured by revising the regulations.

Repeal of the earnings and profits limitation rules cannot simplify the tax laws. The earnings and profits concept is used throughout the Internal Revenue Code, and the staff's preliminary report states that the concept will be retained for other purposes. Most, if not all, corporations will have to continue to compute earnings and profits. for example, domestic corporations will use the concept for affiliated corporations rules, accumulated earnings tax, and section 306 "bailout" purposes, etc. Corporations with foreign subsidiaries will be required to continue to compute earnings and profits for foreign tax credit, controlled foreign corporations, and section 1248 recapture purposes. Under the proposal, the earnings and profits concept is not being eliminated except for dividend determination purposes.

While the simplification of the earnings and profits calculations is a desirable objective, and there is much to be said for developing a better definition of the concept, there is no necessity for the elimination of the earnings and profits limitation on the characterization of distribution as ordinary income.

M. Divided distributions of appreciated property

1. Present law

Generally, a distribution of appreciated property by a corporation with respect to its stock is not a taxable event to the distributing corporation, except in certain redemptions (the *General Utilities* doctrine).

2. Proposal

Any ordinary, non-liquidating distribution of appreciated property would be taxable to the distributing corporation. Certain exceptions of present law (relating to partial liquidations, carryover basis situations and qualifying stock distributions) would remain.

3. Comments

Requiring recognition of gain (or loss) at the corporate level whenever a corporation makes a distribution of appreciated property to its shareholders, even in liquidating distrubitions, would repeal the *General Utilities* decision in its entirety and constitute a fundamental change in the tax law. Such a change would upset many taxpayers' justifiable reliance on long-settled tax treatment and impose an economic hardship on many corporations and their shareholders. The Congress should not undertake such a significant reversal of longstanding tax policy without first identifying and evaluating all its potential effects.

Repeal of *General Utilities* and related statutory nonrecognition rules would extend the present burdens of the two-tier corporate-shareholder tax structure to all corporate liquidations and redemptions. The economic problems caused by the failure to integrate our individual and corporate income taxes are likely to be aggravated, unless a repeal of the *General Utilities* decision is accompanied by some form of relief provision to alleviate this double tax burden.

Furthermore, repeal of the nonrecognition rules of *General Utilities* and Code sections 311, 333, 336 and 337, without any accompanying measures to alleviate the impact of such a change, will discourage smaller taxpayers from adopting otherwise appropriate uses of the regular corporate form. Many small taxpayers will be induced to forego the nontax benefits and protections of incorporation in order to escape taxation of the same gain at two levels. As a result, any increased simplicity and certainty achieved by the Subchapter C revision will risk being effectively undone to the extent that taxpayers opt for a single level of partnership taxation despite Subchapter K's complexities and uncertainties.

If then Congress decides to repeal the nonrecognition rules of *General Utilities* and the corresponding statutory provisions, ICSC urges that the Congress simultaneously enact relief measures to prevent or reduce potential adverse effects of the change. A shareholder credit for taxes paid on appreciation by a distributing corporation would greatly reduce the immediate adverse impact of the proposed rules in many situations.

IV. CONCLUSION

ICSC urges the Committee to be cautious in attempting to deal with the perceived abuses of the partnership, corporate, and accounting rules. It is important that capital formation in the shopping center industry, and in other sectors of the real estate industry, not be impaired by remedies for these problems. Any proposals adopted by the Committee should be carefudly drawn tg affect only those problems that cannot be remedied with strict enforcement of existing law, and not to affect legitimate, non-tax motivated transactions.

Mr. PEASE. Thank you very much, Mr. Szymanski.

Next we will hear from Robert Bennett, representing the National Corporation for Housing Partnerships.

STATEMENT OF ROBERT BENNETT, PRESIDENT, NATIONAL CORPORATION FOR HOUSING PARTNERSHIPS

Mr. BENNETT. My name is Robert Bennett. I am the president of the National Corporation for Housing Partnerships, NCHP, a congressionally chartered corporation which is a general partner in the National Housing Partnership, a limited partnership.

I will summarize my statement, which I have submitted to the committee, as rapidly as I can.

Our organization was created in 1970 pursuant to title IX of the Housing and Urban Development Act of 1968 to "encourage the widest possible participation by private enterprise in the provision of housing for low and moderate income families." This creation was to further the national goals set out in section 901 of that act, to provide a decent and suitable living environment for every American family.

We were set up by Presidential commission and funded by the sale of stock and limited partnership interests to some 270 corporations, financial institutions and labor unions, for a total of $42 million. We are not an agency or instrumentality of the U.S. Government. We are completely private and enjoy no benefit or favor from the Government.

However, we do have 3 Presidential appointees on our 15-man board, and both NCHP and NHP are unique organizations created by the Congress for performing a public mission with funds invested by private citizens.

It was intended by the Congress that private capital would be attracted to the development of low-income housing through the vehicle of tax benefits. From our inception in 1970 through June 30, 1983, we together with investors have provided equity capital to 405 multifamily rental housing properties and 4 nursing homes in 38 States and the District of Columbia and Puerto Rico for a total of 58,000 dwelling units. The estimated replacement cost of this real estate is more than $2 billion.

We have been engaged in developing, managing, and maintaining rental housing projects pursuant to certain programs enacted by Congress, principally section 236 and section 8, as well as other programs. These programs impose restrictions on owners and investors of property as the quid pro quo for various forms of government assistance such as rent subsidies, eligibility of tenant, cash distributions, and limitations on the sale of projects.

Owner-investors do receive certain preferences, however, in the form of lower cost financing and tax benefits unavailable to other forms of real estate. These tax benefits are the primary attraction to investors in new or existing low income housing projects. The tax benefits must be enough to overcome the restrictions I have noted, particularly the severe limitations to cash distributions imposed on the projects.

Briefly, the cash benefits are deductions during the construction period of interest and taxes which are only available as a deduction over a 10-year period elsewhere; next, the phaseout of recapture on the sale of properties starting in the 9th year versus full recapture after the 15th year for other real estate; accelerated depreciation at a 200-percent declining balance rate versus 175, and tax-exempt interest on bonds.

Clearly, the Congress has consciously developed a policy to encourage investment in low income housing by providing tax benefits. My statement reviews the housing problems which Congress has acknowledged are approaching crisis proportions for low and moderate income families, in summary, affordability and availability of rental notes, and the causes, primarily the reduction in government assistance. In addition, I note the provisions of the President's fiscal 1985 budget which calls for a drop of some $20.5 billion in housing subsidies from the levels of fiscal year 1981 as well as proposals on rental vouchers and a moratorium on new construction of section 8 and rental housing rehabilitation.

I also would ask the committee to note that section 167(k) of the Internal Revenue Code has expired, which permits 60 month amortization of rehabilitation expenditures.

The tax proposal which we regard as adverse to low income housing is the treatment of interest attributable to deferred interest payments. Because of the complexity of this issue, I shall quote directly from my written statement. The President's budget message to Congress includes a provision which would have a profound adverse effect on the capacity of the private sector to preserve and maintain the existing housing stock in the country for families of low and moderate income. Since there is no funding authority for new construction or rehabilitation of low income housing, any proposal that would have a negative effect on the ability to maintain, upgrade or renovate the condition of existing housing for low income families must be viewed with grave concern.

The proposal would have substantial adverse effect on the ability of NHP to raise private capital necessary to operate, renovate or upgrade the quality of existing houses. Under the proposal, the original discount rules contained in section 1232(a) of the code would apply for the first time to transactions involving real estate and the payment of services.

Mr. Chairman, in the interest of time, I would note that the effect of these proposals would reduce the tax benefit to investors by approximately 25 percent, and the impact would seriously impair our ability to raise private capital necessary to preserve and upgrade the quality of existing housing.

We would respectfully request that this committee create an exemption from the proposal for the acquisition and operation or management of low-income housing as defined in clauses (i), (ii), (iii), and (iv) of 1250(a)(1)(b) of the code, and also that the committee consider restoring 167(k) provision of the code to encourage the rehabilitation of low-income housing.

Thank you, Mr. Chairman.

[The prepared statement follows:]

Statement of Robert Bennett, President, National Corporation for Housing Partnerships

Summary of Testimony and Recommendations Concerning Administration Proposals Contained in President's Budget Message to Congress

I. INTRODUCTION

A. Genesis of the National Housing Partnership ("NHP")

(1) Congressionally chartered, but privately owned, both NHP and its sole general partner, The National Corporation for Housing Partnerships ("NCHP"), were created in 1970 pursuant to Title IX of The Housing and Urban Development Act of 1968 "to encourage the widest possible participation by private enterprise in the provision of housing for low and moderate income families."

(2) Since its inception, through June 30, 1983, NHP has committed equity capital to 405 multifamily rental housing properties in 38 states, the District of Columbia and Puerto Rico, comprising roughly 58,000 dwelling units having an estimated replacement cost of more than $2,013,744,000.

- (*a*) A subsidiary of NCHP provides management services for 35,760 dwelling units in 42 states and the District of Columbia.
- (*b*) Nature of Government-Assistant programs under which NHP has developed, acquired, and managed multifamily housing projects for families of low- and moderate-income.
    - (1) HUD Section 236 Program
    - (2) HUD Section 8 Program
    - (3) Tax Benefits to attract private capital for investment in low income housing
        - (A) Preference in existing law for low income housing investments relative to other investments in real estate
            - (1) Deductibility of Construction Period Interest and Taxes
            - (2) Phase-Out of Depreciation Recapture
            - (3) Accelerated Method of Depreciation (200 percent v. 175 percent)

II. EFFECTS ON DEVELOPMENT AND OPERATION OF LOW-AND MODERATE-INCOME HOUSING OF RECENTLY ENACTED BUDGETARY CHANGES AND OF NON-TAX PROPOSALS IN PRESIDENT'S BUDGET

(A) Elimination of funding for new construction of low-income housing under Section 8 HUD Program by enactment of 1983 legislation.

(B) Expiration on December 31, 1983, of Section 167(k) of the Code providing a 60 month amortization of expenditures incurred in substantially rehabilitating a low-income housing unit.

(C) Budget Proposal to provide cash vouchers to low-income persons as credit against rental payments.

- (1) No provision in Budget Message (excepting the limited effect of item 3 below) for upgrading, or renovation of existing low income housing projects.
- (2) No provision for funding of new construction of low-income projects.
- (3) New rental rehabilitation program (Section 17) wholly inadequate to meet housing needs.

(4) Proposal represents a reduction in government subsidized housing from 24.8 billion in 1981 to 4.3 billion in 1985.

III. ADMINISTRATIONS TAX PROPOSALS AFFECTING LOW-INCOME PROJECTS

A. Treatment of interest attributable to deferred payments

1. Provisions

(*a*) Extension of original issue discount rules to payments for services and to transactions involving property.

(*b*) Use of compound interest rate under Section 483 effectively deferring larger amounts of interest to later years.

(*c*) Certain exemptions from proposed rules, i.e., principal residence, etc.

2. Effect on low-income housing projects

(*a*) Because of the reduction in tax losses that the proposal would cause as a consequence of shifting interest deductions from the early years of a project to later years, the proposal would have a stifling impact on the ability of NHP to raise the private capital required to upgrade, renovate and improve the quality of living accommodations for low-income families upon the acquisition of an *existing* project.

(*b*) In the absence of a legitimate alternative for upgrading and revitalizing existing low-income housing projects, repairs and renovations of existing projects will not occur and the quality of low-income housing projects will rapidly deteriorate.

3. Recommendations

(*a*) Provide an exemption from the proposal for the acquisition and operation of low-income housing as defined in clause (i), (ii), (iii), or (iv) of Section 1250(a)(1)(B) of the Code.

B. Premature accruals

1. Provisions

(*a*) No deduction for accrual of expenses until economic performance has occurred, i.e., until services are performed or goods provided.

2. Effect on NHP's ability to provide housing for familes of low-and moderate-income

(*a*) Depending on the amount of time that elapses between the moment an obligation begins accrual of interest and the performance of the obligation to which the accrual relates, the proposal could have an adverse impact on the ability of NHP to improve the quality of existing low-income housing, particularly when viewed in conjunction with the proposal discussed in III A above.

(*b*) NHP is currently assessing the effect of this proposal at the present time.

3. Recommendations

(*a*) Adequate protections should be provided for the continued operation and acquisition of low income housing.

(*b*) The effective date of the proposal (in whatever form it is enacted) should be relaxed to prevent ongoing tranactions from being adversely affected.

Statement

My name is Robert Bennett. I am President of The National Corporation for Housing Partnerships ("NCHP"), a Congressionally Chartered corporation which is the general partner in The National Housing Partnership, a limited partnership. I am pleased to address this Committee on certain tax measures contained in the President's Budget Message to Congress that are of direct concern to us and to the interests of low and moderate income housing in the country.

I. CREATION OF THE NATIONAL HOUSING PARTNERSHIP

In order for the Committee to more fully appreciate the role that NCHP plays in the development, maintenance, and operation of low and moderate income housing projects throughout the nation, perhaps it would be helpful for me to provide some background into the genesis of the company. A I mentioned, The National Corporation for Housing Partnerships is the sole general partner in a limited partnership known as The National Housing Partnership ("NHP"). Both NHP and NCHP were created in 1970 pursuant to the direction of Congress contained in Title IX of the Housing and Urban Development Act of 1968 "to encourage the widest possible participation by private enterprise and the provision of housing for low and moderate income families." The National Housing Partnership is a unique organization created by Congress to perform a public mission with funds invested by private citizens. On December 11, 1968, the President's Committee on Urban Housing reported:

"It has been necessary for us to examine the entire complicated process of building American housing in order to find the many particular ways in which costs can be reduced, production increased, and decent housing built for citizens with low incomes. . . . There must be creative action by many institutions and agencies, by government at the state and local level, as well as in Washington, *and especially by private enterprise.* We have proposed many specific improvements in federal housing programs which are intended to encourage greater participation by the business community in the field of low income housing. *We have also proposed a specific new instrument—The National Housing Partnership—to provide another route for business entry into the production of housing."* (Emphasis supplied).

Clearly, based on subsequent lesiglation, it was the intent of Congress to attract private capital to the construction and development of low income housing through the vehicle of tax benefits.

Pursuant to this mandate of Congress, The National Housing Partnership was formed under Title IX of the Housing and Urban Development Act of 1968 with a Congressional Charter that limits its function to the provision of housing for low and moderate income families. In Section 901 of that Act, Congress reaffirmed "The national goal of a decent home and a suitable living environment for every American family" and found that "the volume of housing being produced for families of lower moderate income must be increased" to attain this national objective.

Sixteen leaders of industry, labor and civic organizations were appointed by the President of the United States to organize NHP and NCHP. In 1970, these organizations and private concerns raised approximately $42,000,000 by means of a sale of units of securities consisting of stock in NCHP and limited partnership interests in NHP. The minimum investment was $100,000 and subscriptions were accepted only from business corporations, labor organizations, and financial institutions. Although neither NHP or NCHP is an agency or establishment of the United States goverment, three of NCHP's directors are appointed by the President by and with the advice and consent of the Senate. The remaining directors are elected by the shareholders/limited partners. NCHP is required by law to submit an annual report to the President concerning the status of low and moderate income housing in the nation. Neither NHP nor NCHP receives any special benefits or favoritism from the Federal ggvernment. NCHP curreltly maintains a nationwide staff of 673 full time and nine part time employees of whom 249 full time and seven part time employees are headquartered in Washington, D.C. In addition, NCHP's Property Management subsidiary ("PM") employs an additional 1,283 full time and 203 part time employees at apartment project sites across the country.

From its inception in 1970 until June 30, 1983, NHP has, together with other investors, committed equity capital of 405 multi-family rental housing properties and four nursing homes located in 38 states, the District of Columbia and Puerto Rico, comprising approximately 58,000 dwelling units and having an estimated replacement cost of more than $2,013,744,000. The Property Management subsidiary provides direct management for approximately 35,760 dwelling units in 280 properties located in 42 states and the District of Columbia. NCHP alos provides direct management for 22 properties with 1,659 dwelling units owned by unaffiliated entities and provides supervisory management services for over 17,794 dwelling units and 102 properties where management is provided by others.

A. Nature of government assisted housing

During the period of its operation, NHP has developed, managed, maintained, and operated housing projects for low and moderate income families pursuant to certain programs enacted by Congress. These program include development of low income housing projects under HUD Section 236 and HUD Section 8 Assistance Programs as well as other HUD programs, together with programs administered by state and local agencies. Numerous restrictions are imposed upon the owner/investors of projects constructed under these programs in consideration for various forms of government assistance. For example, a tenant is not eligible to rent an apartment unit in an existing HUD Section 236 program unless his or her adjusted family income does not exceed 80 percent of the medium income in the area of the project. No rents in any project operated under HUD auspices can be increased without the prior approval of the applicable governmental agency, although HUD has issued a final regulation that has enabled some rents to be set without HUD approval. Under the HUD administered programs, various restrictions apply to limit the amount of rent that a tenant must pay. Moreover, cash distributions to the owner/investors of a government subsidized project cannot exceed 6 percent of the original owner's initial equity investment in the project. Futhermore, an owner must obtain HUD's approval before a government subsidized project can be sold or disposed of.

In return for acceptance of these various restrictions imposed by HUD on the operation and management of a low income housing project, the owner/investor receives certain preferences, including favorable financing and certain tax benefits unavailable to other forms of real estate investment. The financial advantage offered to a government subsidized project was an interest rate on the long term mortgage substantially below market. *However, the tax benefits are the primary vehicle for attracting private investor capital to the development and operation of new and existing low income housing projects.* (Emphasis added). In addition to the limitations on cash distributions noted above, cash flow to investors is severly limited by the restrictions on the amount of rent a low income tenant is required to pay. Thus, the only incentive to a private investor is the substantially greater amount of tax benefits to be realized from the investment relative to an investment in other forms of real estate.

Preferences for low income housing that have been carved out under the existing tax laws represent a conscious decision by Congress to rely almost exclusively on the tax laws as a means for attracting private capital to invest in housing projects for low and moderate income families. A list of the preferences available to investors in low and moderate housing as opposed to other forms of real estate include the following:

(i) Immediate deductions for construction period interest and taxes, which are otherwise amortized over a ten-year period for investments in other real estate;

(ii) A phase-out of depreciation recapture upon a sale or disposition of a low and moderate income housing project commences in the ninth year of ownership;

(iii) The availability to an owner of a low income housing project of the most accelerated method of depreciation; i.e., 200% declining balance for low income housing and 175% for other real estate; and

(iv) Tax-exempt interest on bonds issued to finance construction of multifamily housing for low income families.

In short, it is unmistakably clear that the Congress has consciously developed a policy to encourage private investment in low income housing by providing additional tax benefits to those investments that are not available to other real estate.

II. IMPACT ON DEVELOPMENT AND OPERATION OF LOW AND MODERATE INCOME HOUSING OF RECENTLY ENACTED BUDGETARY CHANGES AND OF NON-TAX PROPOSALS IN PRESIDENT'S BUDGET

Recently enacted budgetary changes for government subsidized housing have exacerbated a growing need for living accommodations for low income families. During its consideration of the Housing and Urban/Rural Recovery Act of 1983, the Congress acknowledged that a crisis had developed in recent years in the availability of affordable rental housing in certain market areas. In NHP's operations, we have recently experienced the dimensions of the critical need for rental housing for lower and middle income families when 7,000 applications were received for occupancy for the 216 units in an assisted project in the South Bronx.

This housing shortage is a direct result of substantial reductions in the level of government support for suitable housing to poorer families in the country. According to the Congressional Budget Office's report released on February 1, 1984, evaluating the President's Fiscal Year 1985 Budget, it was estimated that discretionary programs for subsidized housing will drop from a funding level of $24.8 billion in 1981 to $4.3 billion in 1985 if the President's Budget is implemented. Even if the proposals laid out in the President's Budget Message are not enacted, the current policy incorporating budgetary cuts over the past three years reveals that the level of funding in 1985 would still only be $8.8 billion. This immense reduction includes a repeal in 1983 of authority for new construction of Section 8 subsidized housing.

In addition, prior to the submission of the President's Budget Message, Section 167(k) of the Internal Revenue Code, which provides a 60 month amortization for expenditures incurred in substantially rehabilitating a low income housing unit, expired on December 31, 1983. Without this tax incentive, owners of low income housing projects cannot take advantage of what little funding remains in the Section 8 program for substantial rehabilitation of existing units. This development virtually destroys the incentive to raise private capital for the rehabilitation of deteriorated housing for low income families.

The proposals affecting government assisted housing outlined in the President's Budget Message would only worsen an already severe crisis in the ability of the government and the private sector to provide housing to meet the needs of low income families. These proposals include the following items:

A cash voucher program to provide credits to low income persons against their rental payments. While this program deserves further study, it does nothing to encourage either the development of new housing or the preservation of existing housing for low income families.

The moratorium on new construction of low income housing projects under Section 8 is continued.

A new rental rehabilitation program (Section 17), is designed to support the rehabilitation of privately owned rental properties but is anticipated to affect only a small fraction of the existing housing stock in the country. For example, it is estimated during a two year period that no more than 25,000 units will be rehabilitated under the proposed Section 17 program, while HUD estimated in its 1980 annual report that about three million rental units needed moderate upgrading.

II. ADMINISTRATION'S TAX PROPOSALS AFFECTING HOUSING PROJECTS FOR FAMILIES OF LOW AND MODERATE INCOME

A. Interest attributable to deferred payments

The President's Budget Message to Congress includes a series of tax proposals, amongst which is a provision that would have a profoundly adverse impact on the capacity of the private sector to preserve and maintain the existing housing stock in the country for families of low and moderate income. Since there is no funding authority for the new construction or rehabilitation of low income housing, any proposal that would have a negative effect on the ability to maintain, upgrade or renovate the condition of existing housing for low income families must be viewed with grave concern. A proposal in the President's Budget Message that would have a substantially adverse effect on the ability of NHP to raise the private capital necessary to operate, renovate or upgrade the quality of existing low income housing is a proposal referred to as the treatment of interest attributable to deferred payments. Under this proposal, the original issue discount rules contained in Section 1232A of the Code would apply for the first time to transactions involving real estate and to payments for services. Moreover, the proposal would require that interest arising from a transaction subject to the original issue discount rules must be computed at a compound interest rate to be prescribed by statute instead of accruing interest at a simple rate which is allowable under current law.

While the technical explanation of this proposal is quite complex, the primary effect is to defer until later years a substantial amount of interest deductions to a purchaser in a purchase money transaction in which the bulk of the payments are spread over a number of years. Concomitantly, the seller in a purchase money transaction will be required to include in income the amount of interest computed under both the original issue discount rules and the compounding of interest formula irrespective of whether the seller elects the cash or accrual method of accounting. The combined effect of the original issue discount rules and the compounding of interest requirement for the purchaser is to reduce the amount of interest deductions in the early years and increase the amount of the deductions in the later years. The effect is just reversed for the seller/i.e./smaller amounts of income will be reported in the early years (whether interest is paid or received) and larger amounts of interest income in the later years.

The impact of the proposal on the ability of NHP to raise private capital necessary to preserve and upgrade the quality of existing housing is devastating. Because cash flow and distributions in government subsidized housing projects is greatly restricted (no more than 6% of original equity), the major attraction to a private investor in a low income housing project, as previously discussed, is the availability of certain tax benefits that would otherwise be unavailable to him if he chose to invest in other forms of real estate. By reducing the amount of interest deductions allowable in the early years of investment, the proposal will impair the ability of NHP to raise the private capital required to purchase an existing project and to make the necessary improvements in the quality of living accommodations for low and moderate income families. This result occurs because the interest deductions are a significant component of the total package of tax benefits acquired by investors in low and moderate income housing projects. If these deductions are not available, the price that investors would be willing to pay will be correspondingly reduced, and, in the judgment of NHP, will make it economically unwise for NHP to acquire existing housing with a view towards improving the facilities for its tenants. Our rough calculations indicate that 25 to 30% of the equity raised from private investors on the purchase of existing housing projects is attributable to the accrual of interest that would be substantially disallowed as a deduction under the Administration's proposal. Moreover, by requiring the seller to report as income the interest computed under the proposal regardless of whether cash has been paid, the tax liability to the seller will dictate that NHP or any purchaser of property to divert cash to the sellers that could otherwise be used to improve existing projects.

In short, the continuation of the current program under which NHP acquires, upgrades, maintains and renovates existing projects by syndication of a project to investors is tied directly to the availability of interest deductions to investors in the amounts allowable under current law. The Administration's proposal directly threatens the viability of this program.

1. Recommendation

For the reasons discussed, NHP respectfully urges this Committee to create an exemption from the proposal for the acquisition, operation and management of low income housing as defined in clause (i), (ii), (iii), or (iv) of Section 1250(a)(1)(B) of the Code.

The National Housing Partnership was created by Congress not only to provide housing for families of low and moderate income, but also to submit an annual report to the President. In effect, NCHP is the spokesman designated by Congress to advise the President of the status and condition of low and moderate income housing in the country. In discharging this function, the Congress and the President must be advised that the state of low income housing in the United States is declining both in quality and in volume of units to such a degree that it will be difficult in the coming years, absent new provisions in the law, to provide adequate low income housing. The budgetary changes enacted over the past few years have greatly diminished the capacity of the private sector to meet the housing needs of low income families. Funding has been eliminated for new construction of low income housing projects under Section 8, substantial rehabilitation of existing projects will be drastically curtailed by reason of the expiration of tax benefits available to substantial rehabilitation expenditures under Section 167(k), and the drastic reduction in the level of funding for government subsidized housing/i.e./$24.8 billion in 1981 to $4.3 billion in 1985. Since there is no new construction of low income housing taking place in the country and rehabilitation of deteriorated housing units is unlikely to occur in great numbers, it is imperative for Congress to reject any proposal that would adversely affect the ability to preserve, upgrade and improve the quality of existing housing. I would urge in the strongest language possible that this proposal be rejected if it is intended that The National Housing Partnership should continue to fulfill its mandate to Congress "to encourage the widest possible participation by private enterprise in the provision of housing for low and moderate income families."

I appreciate the opportunity to address this Committee. On behalf of The National Housing Partnership, we would welcome the opportunity to work with this Committee and the Congress in an effort to achieve adequate housing in this country for families of low income.

Mr. GIBBONS [presiding]. Mr. Stanger, you may go ahead.

STATEMENT OF ROBERT A. STANGER, CHAIRMAN OF THE BOARD, ROBERT A. STANGER & CO.

Mr. STANGER. I am Robert A. Stanger, president of Robert A. Stanger & Co. We are an independent investment research organization specializing in limited partnership investments. We sell our advice through investment newsletters and reports and through our consulting services, and we are registered with the SEC as investment advisers with respect to our publications, but we do not do any advisory work with individuals, nor do we put together or market limited partnership securities.

We compile statistics on the industry, and we have supplied those statistics to the Internal Revenue Service, the Treasury Department, and the Joint Committee on Taxation.

We supplied the basic number for the Joint Committee's recent report, and I appear here today because I fear that they have misunderstood and, hence, misused these statistics that our organization provided them about the growth of limited partnership investment vehicles; $4.1 billion of the $8.4 billion of publicly registered limited partnerships purchased last year, or 47 percent of it, were securities that were not tax shelters by the definition of the Joint Committee. As Peter Fass testified earlier, they did not result in any mismatch of income and deductions.

More than 40 percent of the publicly registered limited partnership securities were acquired by IRA and Keogh plans in 1983. Most publicly registered limited partnership securities are defined to allow IRA and Keogh plan investment.

The types of publicly registered limited partnership securities that end up in IRA's and Keoghs account for 90 percent of the growth in publicly registered limited partnership sales from 1981 to 1983. Sales of the tax shelter portion, which are essentially the investment in leverage real estate and oil and gas drilling partnerships, remained flat from 1981 to 1983. Oil and gas drilling, that investment segment of it which is the most tax-motivated because of the deduction for intangible drilling cost, actually dropped from $2 billion in 1981 to $800 million in 1983, which we think is prime evidence in the fact that limited partnership investment is dominated by economic and not tax considerations.

We have reviewed 832 publicly registered limited partnership prospectuses in the last 2 years, and have not seen one that relied on the creative use of structural tax rules not intended by Congress, which was the phrase used by the Joint Committee representing their basic complaint about this activity.

Importantly, 90 percent of all publicly registered limited partnerships and 80 percent of all limited partnerships invest in either real estate or oil and gas. Partnerships investing in these two industries accounted for only 20 percent of the IRS shelter case backlog, even though they represented 80 to 90 percent of the money invested and, historically, only 10 percent of the IRS-levied assessments.

Obviously, neither tax shelter nor abusive tax shelter are terms that apply to the great majority of the activity in limited partnerships. The right way to look at this, in answer to the chairman's question before, I think, is the same way that you look at investment companies, mutual funds, real estate investment trusts, or 501(c) trusts for pension funds.

Limited partnerships are income pass-through vehicles that enable passive investors to group their buying power and own diversified portfolios of assets. Since retirement accounts can accumulate income interest free until retirement, and since the value of real estate and oil and gas in the ground may keep pace with inflation, the investment characteristics of real estate and oil and gas limited partnerships match the needs of individual retirement plans and other pension fund accounts.

Congress has seen fit to encourage diversification of pension fund assets, liberalized investment restrictions on them, and improve the ability of all citizens to provide for their own retirement. One impact has been a tremendous expansion of IRA and Keogh plan assets, a portion of which ends up, as it should, in limited partnerships in real estate and oil and gas.

The limited partnership is a more flexible income pass-through vehicle than the investment company or the REIT, because there are fewer regulatory restrictions both in the organization and the operation and the compensation of the sponsor in partnerships. This flexibility is required to attract management to operate successfully as an investor in oil and gas and real estate. The perceived attractiveness of this mousetrap, if you will, leads investors to support the marketing of limited partnerships with both taxable and tax-free investment dollars and, increasingly so, the latter.

This encouragement to capital formation finances a significant amount of new construction in real estate, particularly multifamily residential properties; also, about 25 percent of all domestic onshore oil and gas wells drilled in the United States, year in and year out, are financed through limited partnerships.

More businesses are organized as partnerships than as corporations in the United States, including my own, and I urge you not to paint, as the Joint Committee did, with too broad a brush in attacking the partnership as a basic form of business organization in the United States.

Thank you.

[The prepared statement follows:]

STATEMENT OF ROBERT A. STANGER, CHAIRMAN OF THE BOARD, ROBERT A. STANGER & CO.

My name is Robert A. Stanger. I am Chairman of the Board of Robert A. Stanger & Co., 623 River Road, Fair Haven, N.J. We are an investment research, publishing and consulting firm concentrating in limited partnerships. Some of the statistics we compile on sales of limited partnerships were quoted by The Joint Committee on Taxation in "Proposals Relating to Tax Shelters and Other Tax Motivated Transactions" dated February 17, 1984 presented to the Committee on Ways and Means. The purpose of this transmittal is to set the record straight because the Joint Committee's main premise for the Report was based on an unwarranted and erroneous assumption from our statistics.

Contrary to the opening paragraph in Section C of Section II, activity in the market for publicly registered limited partnerships is not indicative of activity in tax shelters (much less abusive tax shelters). In 1983, 47% of publicly registered limited partnerships capital raised were not for "tax shelters" by the definition used by The Joint Committee ("a tax shelter is any investment which results in a mismatch between deductions or credits in income so that deductions or credits shelter unrelated income from tax"). Of the $8.4 billion of publicly registered limited partnerships purchased in 1983, $4.1 billion acquired existing producing oil and gas reserves, purchased real estate without the use, or benefit, of leverage, and made mortgage loans. We describe this type of partnership as "income oriented" and they are designed for investment by Individual Retirement Accounts and Keogh Plans where the concept of mismatching income and deductions is obviously irrelevant.

In our opinion, the invrease of marketing of publicly registered limited partnerships is directly related to the increase in assets held by IRA's and Keogh Plans. Our estimate is that approximately 30% of publicly registered limited partnership capital was provided by IRA and Keogh Plans in 1983 up from 5% in 1981. Further, 61% of the largest 70 limited partnerships registered with the SEC in 1983 (which accounted for 90% of capital raised) were designed with provisions enabling IRA and Keogh Plan investment.

The statement in The Joint Committee Report is that the growth in publicly registered limited partnership is a mirror of the growth in tax shelters. The facts do not support the conclusion in yet another sense. "Income oriented" limited partnerships increased from $900 million in 1981 to $3.9 billion in 1983 and accounted for 100 percent of the growth in limited partnership sales during the period.

The Joint Committee produced an analysis of reasons for increases in "tax shelter" marketing in the Economic Analysis Section of the Report. Since no such increases are documentable from the record, the explanation for a non-existing phenomenon is pure fiction.

There is a segment of the publicly registered limited partnership market we describe as "shelter oriented" which refers to partnerships that drill for oil and gas and purchase real estate subject to mortgage leverage. In 1981, the sales of "shelter oriented" limited partnerships totaled $3.5 billion. Sales in this category in 1983 totaled $3.4 billion, a drop of $100 million in two years.

Interestingly, the real estate and oil and gas industries have consistently accounted for approximately 80 percent of publicly registered limited partnerships. These businesses are neither the cause of the IRS and the Tax Court overload of "tax shelter" cases nor does audit of them produce any significant percentage of levied assessments. According to IRS statistics, oil and gas and real estate partnerships account for only 20 percent of Tax Court cases (but 80 percent of limited partnership capital raised). Oil and gas and real estate limited partnerships produce only 10 percent of IRS assessments levied, less than even the percentage of cases they represent.

The amount of capital raised in limited partnerships for oil and gas drilling (the most tax motivated publicly registered limited partnership activity due to deductibility under the Tax Code of intangible drilling costs) dropped from $2 billion in 1981 to $800 million in 1983. Leveraged real estate on the other hand, increased from $1.5 billion to $2.6 billion during the same period of time, due in part to expectations for inflation and introduction of the accelerated cost recovery system in the Economic Recovery Tax Act of 1981.

Even in the growing market for leveraged real estate limited partnerships, 53 percent of the capital raised was earmarked to finance new construction or buy properties under construction or recently built. In our opinion, substantially all publicly registered limited partnerships in real estate acquire property from merchant builders and developers as opposed to buying from passive investors. So, this source of capital formation is vital to the construction and development process in the United States.

Capital raised for oil and gas partnerships also serves a vital economic function. Estimates by our company and Chase Econometrics indicate that limited partnership capital drills about 25 percent of all on-shore, domestic oil and gas wells in the United States, year in and year out.

The Joint Committee Report draws a distinction between "tax incentives intended by Congress and the creative use of structural tax rules for results not intended by Congress." In 1982, we reviewed 292 publicly registered limited partnership prospectuses and in 1983 we reviewed 540. (We are the only investment research company with this broad coverage.) We did not see one publicly registered limited partnership that relied on "the creative use of structural rules for results not intended by Congress." To intimate any degree of loss of confidence in the taxing system by the presence or growth of the publicly registered limited partnership business also flies in the face of the actual experience of the IRS auditing these partnerships. No abuse, fraud or evasion has been proven or alleged by the IRS during the fifteen year existence of the publicly registered limited partnership business.

During the last three eyars we have surveyed the 300 largest broker/dealers in the United States about the composition of the limited partnership business. The relationship between publicly registered offerings and private placements is remarkably stable. The public market for limited partnerships represents about 60 percent of the total dolars raised and the private placement market 40 percent.

The private placement market in 1983 for limited partnerships was approximately $6 billion. We estimate $1 to $2 billion represented low and moderate income housing, $1 billion represented renovation and rehabilitation, $1 billion represented real estate net lease transactions (essentially corporate credit transactions) and $1 billion represented oil and gas transactions. The balance of about $1 to $2 billion represelted heavily tax motivated transactions. The Joint Committee's "Proposed Limitations" speak directly to some practices utilized in these heavily tax motivated transactions.

We have concluded that "abusive shelters" (by IRS definition), as opposed to heavily tax motivated transactions, account for about 10 percent of the private placement market for limited partnerships and none of the publicly registered market. Most abusive shelters are not involved in real estate or oil and gas activities as the previous statistics cited on IRS audit experience indicate. "Abusive shelters" are about 4 percent of the total market for limited partnerships, a number in line with published IRS estimates of revenue loss for this activity.

Surprisingly the percentage has not declined in recent years while measures to identify and penalize purveyors and purchases of "abusive shelters" have been increased substantially with the passage of the Economic Recovery Tax Act of 1981 and the Tax Equity and Fiscal Responsibility Act. In as much as there is traditionally an 18 month to 22 month delay between filing of a tax return and the beginning of an audit, one would not expect full impact of the recent measures until sometime during 1984. This lag may account for the tremendous build up in Tax Court cases and in the IRS audit backlog. Only after the audit process ensnares enough investors seeking "abusive shelters" will the original sale be thwarted. Since penalties for engaging in "abusive shelter" activities are now severe, we would expect a reduction in the creation and sale of "abusive shelters" in future years because of existing legislation.

Mr. STARK [presiding]. Thank you, Mr. Stanger.

Our next witness is Mr. Moses, the president, chairman, and chief executive officer of the National Investment Development Corp.

STATEMENT OF STEPHEN D. MOSES, CHAIRMAN, PRESIDENT, AND CHIEF EXECUTIVE OFFICER, NATIONAL INVESTMENT DEVELOPMENT CORP.

Mr. MOSES. Thank you, Mr. Chairman.

As you said, my name is Stephen Moses. I am from Los Angeles, and I am the chairman of the board of National Investment Development Corp., a company which specializes in infusing fresh capital to aging and deteriorating subsidized housing projects.

I have submitted a written presentation, but I would like to address, in this presentation, just two issues which lie unequally on subsidized housing. They may reduce the benefits of all real estate, but they have a specially chilling effect on subsidized housing, and especially the bringing of new capital to subsidized housing.

The subsidized housing legislation, in its legislative history and in its effect, requires that virtually no cash be distributed to the owner, and that the owner's economic benefits, rather, come from tax incentives, near-term tax benefits and, ultimately, long-term capital gain.

As property ages, it is typical either for ownership to change hands, or for an owner to put new money in and refurbish it; too, that the new owner or the old owner, in the case of subsidized housing projects, there is no vehicle for bringing new money to an old project by the old owner.

First of all, there is no requirement that the old owner put in for the capital; second, if he does, HUD will not recognize any allowable return on that capital; and, third, if tax benefit is indeed his incentive, there is virtually little, if any, tax benefit left in a project that is 8, 10 or 12 years old; yet, none can deny, it often needs new capital.

The vehicle that is involved to perform that function of bringing new capital to aging projects is a transfer to a new owner. At that time, HUD has the ability which it exercises to require that the new owner address the physical and financial needs of the project, so that it is brought back to first-class shape.

Since the project does not distribute any cash, there is no way for the buyer to pay to the seller any cash, other than in the form of a second mortgage, which does not currently service its debt. In other words, since there is no cash flow from the project, the second mortgage that is placed on the property must accrue interest, rather than have that interest be paid.

Currently, there in no vehicle, there is nothing from the project to pay the interest under the originally issued discount rules if applied to subsidized housing.

The seller would have to recognize phantom income over a number of years while he waited for the subsequent buyer to seek his buyer, his seller, sell it, refinance it, 10, 20 years later, then pay him off on his second mortgage. That would be such a chilling effect that no seller would sell and, indeed, would rather hold the property and allow it to deteriorate while the Government had no ability to require him to put in further money, and the housing stock, already in short supply, would diminish even further.

A second aspect of the proposed legislation which would have a chilling effect on such transfers is the related parties provision. Frequently, the managing general partner of the project originally is the only person really capable, or at least the best person capable of carrying forward that project, but in order to raise the new capital needed to bring the property back to its best standards, he effects a sale from one group of investors to another group of investors. The mere continuity of the general partner from the first owner to the second owner should not be deemed a related party in such a way as to deny the benefits of the tax law that would otherwise apply to that sale.

I would like to momentarily address a question that was raised by Mr. Moore, who unfortunately is not here now.

He asked whether or not the subsidies that are provided for by HUD, which are currently not being impressively funded, could replace the tax benefits which we are dealing with in this bill. The answer is that it is apples and oranges. The incentives granted in the HUD legislation to housing projects flow to the tenants by means of reducing the cost of occupancy. None of those benefits flow to the owner of the property.

The sole benefit going to the owner of the property are the tax savings he could effect through this shelter legitimately created under the tax laws. There is not a tradeoff between the two.

There has not been any evidence that there has been an aggressive rush of capital to subsidized housing. Indeed, there is a great shortage.

To enact tax reform which would reduce the flow of capital to subsidized housing would bring about a further deterioration of the housing supply, and would not perform the public service.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF STEPHEN D. MOSES, CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL INVESTMENT DEVELOPMENT CORP.

SUMMARY

(1) Because of the strict limitations on cash distributions to owners of government-assisted housing projects, the bulk of the incentives which attract private investment capital to these projects consist of tax benefits.

(2) Existing owners of 10–15 year old projects generally have no incentive to contribute additional funds for the rehabilitation of these projects because their tax benefits have been exhausted and because any additional capital contributions will not increase their rate of return.

(3) Further, tax benefits become even more significant in attracting new capital for the rehabilitation of existing projects since projects in need of rehabilitation

rarely have any distributable cash whatsoever, and some of the potential appreciation in the project must be paid to the sellers in order to effect a transfer.

(4) Other tax benefits accorded to government-assisted housing, such as IDB-financing, subsidize project operation but do *not* increase the return to private investors. Only the tax benefits of depreciation and interest deductions do that.

(5) Accordingly, in order for transfers and rehabilitation of government-assisted housing to continue, it is necessary that financing placed on such housing in connection with a transfer thereof, be exempted from the deferred payment and related party provisions of the pending tax reform legislative proposals.

STATEMENT

My name is Stephen D. Moses. I am Chairman of the Board, President and Chief Executive Officer of National Investment Development Corporation ("NIDC"), a corporation which is engaged in raising investment capital for government-assisted housing projects. I am also a director of the National Housing Conference and a member of the Advisory Group to the Democratic Caucus Housing Task Force. In the past, I have had the privilege to serve as Advisor to President Johnson's Committee on Urban Housing (the "Kaiser Committee") and as a member of President's Nixon's Task Force on Low Income Housing (the "Saulnier Committee").

For the last 9 years, I have concentrated on bringing fresh capital to 8 to 15 year old HUD-assisted projects. Most real estate changes hands about every 5 years. Each new owner makes refurbishments—sometimes minor touch ups; sometimes major renovations; more often something in between. Government-assisted housing changes hands less frequently; yet the old (original) owner is generally unable or unmotivated to invest in rejuvenating the project. The mechanism for such changes of ownership is burdensome and tedious, and the economic benefit of new owership is hard to discern because actual cash flow is limited or proscribed.

Government-assisted housing can be owned by only two kinds of entities: non-profit entitles who, almost by definition, have no capital to infuse, or limited distribution entities who receive virtually no cash return. (Federal law limits allowable cash return to a lesser figure than the yield on a savings account.) Thus, the investment incentive consists largely of tax benefits. Congress has recognized this continually, both in legislative history which is replete with references to the tax benefits intentionally granted to subsidized housing, and in the recurring tendency of Congress after Congress to exempt subsidized housing from so-called "tax reform" legislation.

An example of what can be done occurred just down the street. A non-profit project was on the brink of economic disaster. Repairs went unmade and the mortgage could not be paid. HUD was on the brink of a $5½ million claim against its insurance fund. We stepped in; purchased the project; kept the mortgage current; made the repairs, and met the housing needs of hundreds of families at minimal cost to the government. I have participated in over a hundred similar situations.

Thus, the thrust of my testimony today will be to urge you to continue to exempt government-assisted housing from any "reforms" you propose to enact. Failing that, I urge at least such exemptions to two elements of your proposals: the "deferred payment" and "related parties" provisions, in order to preserve the market for revitalizing such housing.

Background information on government-assisted housing

Existing federal tax incentives are necessary to attract private capital to government-assisted housing because low-income tenants cannot afford rents which are sufficient to cover operating expenses, much less to make housing competitive with alternative investments apart from the tax savings. Government-assisted housing is subject to ceilings on rent charges and to restrictions on cash distributions to owners (which generally range from 6–10% of original equity capital) imposed under various subsidy programs. Moreover, all rental housing must compete for private investment not only with the substantial tax advantages which are available for owner-occupied housing, but also with alternative investments, many of which appear less complicated and more attractive. The fact that it has been difficult to attract new capital to government-assisted housing indicates that current tax benefits are barely adequate.

Federal housing subsidy or guaranty programs, funding for which has now been substantially eliminated, generally provided either mortgage insurance, low-cost mortgage financing and/or guaranteed rental income, each of which subsidizes project operations. However, these programs do not enable a project to offer a competitive rate of return to private investors since strict limitations on distribution of project income to owners are contained in most project regulatory agreements. The incentives for private investment in government assisted housing are derived largely from tax benefits.

Many government-assisted housing projects which are 10 or more years old are currently in need of cash infusions. Often these projects have depleted maintenance reserves and are unable to meet unanticipated energy costs or other unforeseen expenses. Except in the most unusual cases, existing owners will not be willing to invest additional amounts in these projects—and, generally, they cannot be forced to do so—because (1) these projects cannot generate an adequate rate of return at affordable rent levels which would support additional investment by the current owners and (2) they have exhausted their ability to generate further tax benefits to current owners.

In addition, current owners, who are not at risk for deficits in project operations, will be reluctant to incur the tax liability resulting from a disposition of their project unless they can obtain cash proceeds at least equal to this tax cost. At the same time, recapture provisions are a disincentive to premature transfers. Since 1981, ACRS has provided substantial additional tax benefits to new owners who acquire existing properties. Thus, ACRS has facilitated project transfers which will provide needed capital for rehabilitation and improvement, after both the recapture penalty and original tax benefits have been depleted, by enabling new investors to afford the cash payments demanded by the existing owners.

Typically, a sale of a government-assisted housing project takes place between two separate investment partnerships. Investors in the buying partnership contribute cash, commonly over a 3 to 5 year pay-in period, which will be used to satisfy the physical and financial needs of the project and to compensate the seller. For example, the Department of Housing and Urban Development ("HUD") guidelines for transfers of HUD-financed or HUD-insured housing projects require that a project be restored to sound physical condition (including restoration of any deferred maintenance reserves) within 24 months of the time of transfer and, in addition, that all necessary capital improvements (including energy-related alterations) be completed within an acceptable time frame. Finally, accounts payable must be cleared and project reserves funded to acceptable levels within 18 months from the date of transfer and for the foreseeable future.

In many cases, satisfaction of these criteria will require substantial amounts of cash. It is clearly in the interests of both the project and the new investors that these amounts be expended and that project operations be restored to a break-even level. On the other hand, available cash from the buyers which might otherwise have been used to compensate the sellers for the value of their assets will be required to be spent on the project. Thus, in lieu of cash, the buying partnership will generally give the selling partnership a second mortgage or note with a term which often corresponds to the remaining period of tenant occupancy restrictions or to the remaining term of the first mortgage. Many government-assisted housing projects have fair market values which exceed the amount realizable during the period of regulated low-income use. Secondary financing permits the existing owners to retain and realize this value in the future, thus encouraging them to part with a valuable asset which would otherwise deteriorate for lack of new investment. The function of this secondary indebtedness is primarily to compensate the sellers for capital appreciation in their property which cannot be realized currently due to regulatory restrictions on distributable cash.

Under many regulatory agreements governing government-assisted housing projects, the amount of cash which may be distributed annually to owners is generally limited to 6 percent (but in no event more that 10 percent) of the project's original equity. Thus, the cash return is not increased by the subsequent investor contributions of the new owners. Accordingly, most interest owed by the buying partnership on secondary indebtedness incurred in connection with a transfer cannot be paid by the buying partnership until a resale or refinancing of the project occurs, generally at the end of the second mortgage term. The total amount of debt carried by a project at any time after a transfer will generally equal the remaining unamoritized principal balance of the first mortgage plus the principal amount of the secondary financing plus the accrued but unpaid interest on such secondary financing.

A buyer is generally willing to issue secondary financing in connection with a purchase of low-income housing because the interest which accrues thereon is deductible against current income. This current tax savings compensates the buyer for the loss of the portion of the capital appreciation in the project represented by the principal and accrued interest on the second mortgage. Further, the full principal amount of project indebtedness is includable in the basis of the new investor limited partners for purposes of computing the ACRS depreciation deductions allowable for the project. However, while the current tax benefits realized from secondary financing might encourage buyers to issue debt which exceeds the value of the project, guidelines for HUD approval of transfers of federal housing projects under its jurisdiction strictly limit the amount of secondary financing which may be placed thereon.

If a project is more than 5 years old, the HUD guidelines state that the total of (1) the outstanding mortgage balance of the primary (HUD/insured or HUD-held) mortgage plus (2) the face amount of any secondary indebtedness, plus (3) the projected amount of accrued but unpaid interest on that secondary indebtedness at any given time after the transfer, may never exceed 75 percent of the replacement cost of the project as of the time of the transfer. Only the HUD national office has authority to waive this restriction in cases where the fair market value of the project is demonstrated to exceed this guideline amount. Thus, these guidelines insure that secondary indebtedness cannot exceed an amount which is presumptuably reasonable in relation to the construction cost of comparable housing. In addition, the IRS polices the amount of secondary indebtedness on all real estate sales and has the legal authority to disregard any non-recourse debt which exceeds the fair market value for the property securing it.

Effect of the Administration's "Accounting reform" proposals on transfers of government-assisted housing

The Administration's "time value of money" proposals include a proposal to change the tax treatment of interest accruing on deferred payment sales which would affect interest on financing incurred in connection with low-income housing transfers. These proposals would alter the economics of all transfers of government-assisted housing in three significant respects. First, the amount of interest accruing on a purchase-money (second) mortgage would have to be computed using compound interest rates rather than simply interest rates, thereby reducing the amount of interest which can be deducted by the purchasers in the early years. Further, this compound interest computation would increase the overall percentage of the total indebtedness which is deemed to represent interest and, correspondingly, reduce the total amount allocated to principal. Since the principal portion of the indebtedness is included in the buyer's basis for computing subsequent ACRS depreciation deductions, the compound interest computation has a compound effect. The purchaser's deductions for both depreciation and interest in the initial years of ownership would be reduced, considerably lessening the tax incentives for new investors to contribute needed capital to deteriorating government-assisted housing projects.

Finally, the deferred payment provision would also treat these second mortgages as original issue discount obligations, thereby requiring that the seller recognize current income equal to the interest deductions claimed by the buyer. Since regulatory restrictions on distributable cash from government-assisted housing projects effectively prevent new project owners from making current mortgage payments to sellers to cover this tax liability, the sellers of a low-income housing project in the future will incur "phantom" income requiring the payment of actual tax dollars each year (i.e., without receipt of cash with which to pay them). If enacted, this provision would make many existing owners—who, because of the nature of the limited partnership vehicle, have no additional obligation to contribute funds to a housing project—unwilling to consent to a transfer which would give rise to annual tax liability without any corresponding annual income. Thus, if this provision is enacted, many low-income housing projects which are desperately in need of cash infusions will not be rehabilitated because their existing owners will elect to retain them rather than incur an annual, out-of-pocket tax liability for 10–30 years. The result will be further deterioration of these projects, higher rents to low-income tenants and an increase in defaults on federally-insured mortgages at a direct cost to the federal government.

Accordingly, it is essential that government-assisted, low-income housing be exempted from the deferred payment proposal in order to permit the continuing rehabilitation and preservation of existing housing as a national resource.

Effect of the related party provision of H.R. 4170

In addition, I would like to mention one provision of H.R. 4170 which would have a comparable chilling effect on the rehabilitation of existing low-income housing projects. Section 492 of H.R. 4170, as passed by this Committee, would disallow accruals of interest on secondary financing payable to a related cash basis taxpayer. A partnership and any of its partners are deemed related for this purpose. This provision would affect interest accruals on secondary financing in connection with low-income housing transfers in situations where there is a carryover general partner.

Because of his day-to-day management responsibility, the existing general partner is the person who is most acutely aware of the current and future needs of a housing project. If he undertakes a continuing general partner role in a new owner partnership, he will have a clear self-interest in providing for all project needs, and, under the securities laws, he will be required to disclose to prospective new investors all information known to him concerning the project's condition and prospects. Accordingly, in a well-managed project, the existing general partner will be in the best position to structure a transfer which will meet the needs of the project, of its existing owners and of the new investors.

Further, in an arms length negotiation the cost of bringing in a new general partner can itself be substantial. A new general partner with no prior stake in a housing project will exact a substantial price for accepting the new (to him) ownership risk. Generally, this price will consist of a significant profits interest (which is not limited by ACRS anti-churning rules as the carryover interest of an existing general partner would be), a favorable management contact and/or a portion of the proceeds from the transfer. Thus, retaining competent existing management can also increase the amount of new capital which is available for investment in the project.

Conclusion

The disallowance or curtailing of a buyer's current interest deductions attributable to secondary financing, or the alternative requirement that sellers recognize interest income currently before it is received, will so radically change the economics of transfers of government-assisted housing projects as to significantly curtail this market. ACRS and the other tax benefits under current law have permitted transfers of these projects to be structured so as to satisfy the needs of the existing owners and still provide an adequate rate of return to new investors. Tax savings are an essential component of this rate of return because regulatory agreements strictly limit the cash which can be paid out currently and because low-income tenants cannot afford rent levels sufficient to generate competitive rates of return. If the tax benefits to new investors, consisting primarily of interest accruals and ACRS depreciation deductions, are curtailed because of the operation of the deferred payment and related party transaction provisions, or if transfers are made prohibitively expensive to sellers, vital existing housing resources will be lost. Thus, an exemption for transfers of government-assisted housing projects is needed under both the related party provision of H.R. 4170 and the deferred payment provision of the Administration's tax proposals.

In conclusion, based on personal experience, I believe that government-assisted housing is an important resource which should not be wasted and that existing tax incentives are the only presently-available means of preserving it. I would be happy to answer any questions the Committee might have.

Mr. GIBBONS [presiding]. Thank you.

We are often told that Treasury would be a lot better off if we just exempted your industry from taxes entirely.

What have you got to say to that; that we would save money if we just said there were not any taxes on shopping centers, and no taxes on housing, and no taxes on any of these things?

We would sure save a hell of a lot of trouble with accountants, lawyers, and auditors, and I am not even counting the gain there. It is our impression we do not collect any taxes out of you all anyway, so why do we not just exempt you from taxes?

Mr. MOSES. Mr. Chairman, may I answer that?

Mr. GIBBONS. Yes, sir, go ahead.

Mr. MOSES. The system, as it has evolved over 30 or more years, has provided, in fact, a rent subsidy to everyone occupying real estate in any form, and that permeates the entire economy.

The fact is that an owner of real estate will accept a lesser cash return because he has certain tax benefits. If you were to take away those tax benefits, you would cause a gigantic increase in the cost of rental to businesses, to industry, to residents of low and moderate income housing, to residents of all kinds of housing, because those owners would require much higher rent in order to get a cash flow competitive with other investments.

Mr. GIBBONS. Would not the price of real estate just come down?

Mr. **Moses**. Only momentarily, and perhaps briefly as a first step. But as Will Rogers said, they ain't making any more of it.

Mr. **Szymanski**. I think the same effect would take place in the shopping center industry if the tax burden was increased. In fact, the rents to the tenants, and then the cost of goods to the customers would all rise.

Mr. **Gibbons**. Why should you be subsidized?

Mr. **Stark**. Mr. Chairman, if I could just add a number—the staff pointed this out to me, just to get it into perspective.

In 1982, the Internal Revenue Service reported that net rental income—this is all rental income from all returns—was a negative $8 billion. So we would start out right there with your proposal.

In other words, if you take all of the real estate returns in the country, they reported a negative rent of $8 billion or a negative income. So, just if we got even with the board, as you say, and make all of real estate tax free, we would pick up $8 billion in income right off the top.

Mr. **Stanger**. The essential benefit in these activities is capital cost recovery through depreciation and depletion, if you want to include oil and gas as well as real estate.

Mr. **Stark**. Could I interpret one more time?

Mr. **Stanger**. That same ability to recover capital cost is allowed to every corporation in the land.

Mr. **Stark**. Could we just separate oil and gas here for a minute, Mr. Stanger?

You said something about the number of publicly registered partnerships not increasing. First of all, is it not true that they eliminated high net worth people from needing to register, so that the big abuse is being basically in the private placements, but the number of registrations was lowered because they exempted the number of 35 people if you had over a couple of hundred thousand in net worth?

Also, the oil business went to hell. I mean I have a hard study. If you separated them, you would find that real estate went up and oil went down, but that is just because of the economics of the industry.

Mr. **Stanger**. According to our own and the NASD figures, the number of registrations of public partnerships of all kinds almost doubled from 1982 to 1983, from 292 to some 540, No. 1.

No. 2, we have surveyed, for a number of years, 300 or more broker dealers to ascertain their activity in these partnership markets, and we have always found and continue to find that public partnerships represent a significant majority of all partnerships that are formed and sold.

Mr. **Stark**. You are talking about partnerships. How about assets?

Mr. **Stanger**. And assets as sold as securities offerings.

Mr. **Stark**. I just wanted to suggest that maybe adding oil in was disingenuous on this because of the decline in activity of oil partnerships with the drop in the price of oil.

Mr. **Stanger**. The figures were influenced by that, there is no doubt about it, which is a testament to the fact that economic and investment considerations motivate the transaction, and not tax considerations.

Mr. MOSES. Can I add to the question about eliminating tax benefits altogether from real estate back to subsidized housing for a moment?

Mr. GIBBONS. We are not talking about eliminating the benefits. We are just talking about not taxing you, period. Just no income tax. You get off scot-free.

Mr. STARK. We would save $8 billion. We would have $8 billion more income reported if you were not allowed to go below zero.

Mr. GIBBONS. That way, we could reduce taxes and save money.

Mr. MOSES. If you did that with regard to subsidized housing which, again, is the narrow focus of my testimony for one moment, the cash that is distributable from subsidized housing is limited by governmental law.

First of all, it rarely occurs with less than half the projects. It is limited by law.

Mr. GIBBONS. Every time I hear from you all, you are going broke, all the way to the bank.

Mr. MOSES. The law limits the return to less than a savings account would give, and makes it a lot more risky.

Mr. GIBBONS. Why in the world do you throw your money away like that? You are wise, intelligent, handsome-looking men, I do not know why you are throwing away all your money.

Mr. MOSES. On the last comment, I admire the chairman's judgment. [Laughter.]

The reason is the tax incentives which you are suggesting be eliminated.

Mr. GIBBONS. You know, I was in Congress in 1968, and I paid a reasonable amount of attention to what was going on and, in fact, real close attention because I was trying to get on the Ways and Means Committee then. I want to tell you, this is one of the best-whispered tax shelters I ever heard of that ever went through.

I tried to follow it. I tried to follow everything that had to do with taxes, and never heard anybody discuss this gigantic giveaway we have here.

I think we have got to put an end to it. You know, America has got a $200 billion deficit, and you all benefit from the most ridiculous of everything we have ever done.

We can abolish all of your taxes and pick up $8 billion worth of revenue.

Mr. STARK. Half of that, probably, $8 billion in income.

Mr. GIBBONS. By abolishing all of the taxes altogether—you know, if people really understood that, they would think we are crazy.

Now, how do we solve this problem in some sensible fashion? I guess we cannot. Maybe we ought to just go ahead and abolish all the taxes on it, and see what happens.

Does anybody else have any questions?

Mr. STARK. Mr. Chairman, I have one other question for the record.

I did not hear Mr. Bennett's testimony, but what are the typical writeoffs in a low-income housing situation, Mr. Bennett? I have got the broker dealer factsheet here on a K mart type deal, and they are advertising almost 5 to 1 over the 5 or 6-year life and about a 2 to 1, or 1.85 to 1 in the first year.

What, in the syndications of low-income housing, what kind of ratios do you offer the investors?

Mr. **Bennett**. They typically run somewhere between 2 and 2½ times the investment over the 5-year period in which the investor pays in his investment. Over the life of the properties, they typically run, on a projected basis, 3½ times, and the assumptions that the projections are made on is that the property is sold for $1 over mortgage after 15 years of useful life.

Mr. **Stark**. Sold for $1 over the mortgage, 15 years downstream?

Mr. **Bennett**. Yes, sir; in other words, we do not project any real estate appreciation.

Mr. **Stark**. Is that a realistic projection?

Mr. **Bennett**. I think the jury is still out, sir.

Mr. **Stark**. Is that unique to subsidized housing?

Mr. **Moses**. Mr. Stark, can I say we have been involved in about 200 second sales of HUD projects. It is not a realistic assumption, but from a securities point of view in terms of projection, you can project the profits you might make in 15 years.

What technically seems to happen is, the new buyer pays a little bit of money to the seller, a lot of money to refurbish the project, and that is to what I address my testimony. The second mortgage will accrue interest because after the project is 20 years old, anytime after that, it can be refinanced free and clear of its Government restrictions. When that happens, then the original owner second mortgage would be paid off, and whatever profit the second owner might have obtained would also be paid off.

Mr. **Stark**. How can we, Mr. Moses—I mean I have no quarrel on new subsidized housing, on new low-income housing. But how can you establish any correlation between the guy who sells out—how do we know that he is going to turn around and reinvest in more subsidized housing?

It does not seem to me that we have any assurance that what we are being encouraged to give the taxpayers' dollars away for is going to—if we did it like involuntary conversion, you would say hold it in escrow until the guy buys some more low-income housing.

You might get some help from me, but just to let the guy walk away with his profit and assume that he is going to turn around and reinvest does not quite convince me.

Mr. **Moses**. The seller has a substantial tax penalty. He pays a substantial tax on sale. He does not walk away unless he invests in another project.

There is a provision that allows him to rollover to a new project, but if he does not, he pays substantial taxes.

Mr. **Stark**. It has to be all low-income housing? Or is a percentage?

Mr. **Moses**. No; it has to be all low or moderate income housing as defined by the National Housing Act.

Mr. **Stark**. Mr. Chairman, the only other thing, I would like to ask permission to put into the record a copy of the broker dealer fact sheet on Blue Field Associates as an example of the type of limited partnership operation that is being marketed in California.

Mr. **Gibbons**. Without objection, we will place it in at this point in the record.

[The information follows:]

National Property Analysts, Inc.

BROKER-DEALER FACT SHEET

BLUEFIELD ASSOCIATES

$10,348,800

56 LIMITED PARTNERSHIP INTERESTS AT
$184,800 PER UNIT PLUS INTEREST

Year	Capital Contribution	Taxable Income (Loss)	Loss Ratio	Cash Flow
1983 (2 months)	$ -0-	$ (18,152)	N/A	$ -0-
1984	30,800	(86,545)	2.81	-0-
1985	30,800	(86,879)	2.82	707
1986	30,800	(87,882)	2.85	1,061
1987	30,800	(83,689)	2.72	1,414
1988	30,800	(84,618)	2.75	1,768
1989	30,800	(71,513)	2.32	2,121
1990		(56,383)		2,121
1991		(55,263)		2,121
1992		(54,144)		2,121
1993		(45,953)		2,121
1994		(44,833)		2,121
1995		(43,714)		2,121
1996		(34,639)		2,121
1997		(33,270)		2,121
1998		(27,633)		2,121
Subtotal	**$184,800**	**$(915,110)**	**4.95**	**$26,160**

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Organization

Bluefield Associates (the "Partnership") is a Pennsylvania limited partnership.

Partnership Business

The Partnership has been formed to acquire, own, and operate a fee interest in five high-quality properties and a leasehold interest in a sixth property in the following locations:

1. Bluefield, West Virginia
2. Ahoskie, North Carolina
3. Wheelersburg, Ohio
4. Borger, Texas
5. Las Vegas, Nevada
6. Media, Pennsylvania (leasehold)

The properties are anchored by major national retailers with high credit ratings.

Sponsor and General Partner

National Property Analysts Partners is the Sponsor of Bluefield Associates. The Sponsor is an affiliate of National Property Analysts, Inc. (NPA), an integrated real estate development, management, and syndication firm. NPA is the largest developer of open shopping centers in the United States.

During the past seven years, NPA, through its affiliates, has syndicated 110 shopping centers, and now manages over 11 million square feet of shopping center retail space. NPA has raised approximately $300 million through more than 60 limited partnerships involving approximately 2,000 investors.

All of NPA's prior syndications are currently operating and have met their obligations. Substantially all have achieved their projections.

The General Partner of Bluefield Associates is Lawrence Zaffuto. Mr. Zaffuto is a registered representative employed by a broker-dealer. Mr. Zaffuto has a net worth in excess of $1,000,000 and is independent of the Sponsor and its affiliates.

Partnership Objectives

1. Preservation of each Limited Partner's invested capital
2. Tax Losses to offset income from other sources:
    - approximately 2.8 to 1 during contribution "pay-in" period
    - [redacted]
3. Annual cash distributions
4. Capital appreciation with capital gains treatment of sale

Property Profile

Description

Bluefield Plaza is a shopping center located in Bluefield, West Virginia, on approximately 11.3 acres of land. The Major Tenants are K mart, a Kroger supermarket and a SupeRx drug store. The center, which is approximately 14 years old, contains 125,292 square feet of gross leasable area. In addition to the Major Tenants, which rent 86% of the gross leasable area, there is space for 12 Local Tenants, 9 in the store area and 3 located in free standing structures. Currently, one store has been vacated, although rent is still being paid. Seven of the Local Tenants have been in occupancy for over 10 years.

Newmarket Shopping Center is located in Ahoskie, North Carolina on approximately 10 acres of land. The Major Tenants are Rose's department store, an A & P supermarket and a Peoples drug store. The center, which is approximately 8 years old, contains 105,156 square feet of gross leasable area. In addition to the Major Tenants, which rent over 86% of the gross leasable area, there is space for 12 Local Tenants.

Wheelersburg Shopping Center is located in Wheelersburg, Ohio on approximately 13.86 acres of land. The tenants are Rinks discount department store, a Kroger supermarket, The Goodyear Tire and Rubber Company and the Tandy Corporation. The center which is approximately 9 years old, contains 136,122 square feet of gross leasable area (8,200 square feet is designated expansion space for Kroger).

The Media Property, located in Media, Pennsylvania, is situated on approximately 9 acres of land and is part of the Granite Run Mall, which is a regional mall anchored by Sears and Gimbels. The Partnership is acquiring only the J.C. Penney department store. The land under the J.C. Penney's is subject to a Ground Lease. The J.C. Penney contains 160,078 square feet.

The Borger Property, located in Borger, Texas is situated on approximately 2 acres of land. The property contains a Safeway supermarket consisting of 31,750 square feet of gross leasable area.

The Las Vegas Property, located in Las Vegas, Nevada is situated on approximately 3.8 acres of land and contains a building originally constructed for use as a Safeway supermarket. This building contains approximately 38,750 square feet of gross leasable area and was leased to Safeway Stores, Incorporated in August, 1978. Safeway has recently closed the supermarket and has indicated to the Sponsor that it intends in the future to open a "Liquor Barn," a subsidiary operation of Safeway.

Market Areas

Bluefield, a city of approximately 17,800, is located in the southernmost part of West Virginia on the Virginia border, approximately 100 miles south of Charleston and West of Roanoke. Bluefield is the commercial, business and railroad center of southern West Virginia. Bluefield's immediate trade area has an estimated population of 47,000. Total retail sales within the immediate trade area were approximately $250 million in 1981.

Ahoskie is the largest community in Hertford County, located in northestern North Carolina, 65 miles south of Norfolk, Virginia and 120 miles east of Raleigh. The immediate retail trade area has a population of approximately 57,000 with total retail sales in 1981 of approximately $100 million.

Wheelersburg is located 5 miles southeast of Portsmouth, Ohio which is the County Seat of Scioto County and the atomic energy and trading center for southeastern Ohio. The immediate retail trade area has an estimated population of 85,000 with total retail sales of $365 million in 1981.

Media is located in Delaware County, approximately 10 miles southwest of Philadelphia. The immediate retail trade area has a population of 568,000 with total retail sales of approximately $2.2 billion for 1981.

Borger is located in Hutchinson County in the Texas Panhandle approximately 50 miles north of Amarillo. The Borger retail trade area has a population of 38,700 and recorded retail sales in 1981 of approximately $88 million.

Las Vegas, the largest city in Nevada with a population of approximately 185,000, is the County Seat of Clark County. The immediate retail trade area has a population in excess of 428,000 and recorded retail sales in 1981 of approximately $2.9 billion.

Anchor Tenants

K mart Corporation — the nation's second largest retailer of general merchandise. K mart's profit for the first half of 1983 was $162.3 million, up from $66.5 million in the first half of 1982.

J. C. Penney — the nation's third largest retailer of general merchandise. For the first half of 1983, Penney posted profits of $113 million on sales of $4.995 billion.

Safeway Stores, Inc. — the nation's largest supermarket chain operation. For the first half of 1983, Safeway reported profit of $61 million on sales of $8.5 billion.

Kroger Co. — the nation's fourth largest retailer and second largest supermarket chain. Kroger's profit for the first half of 1983 was $56.8 million on sales of $6.95 billion.

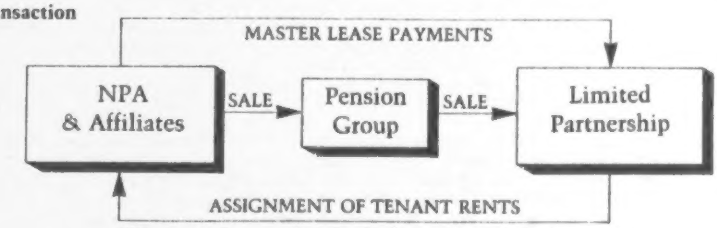
Rose's Stores, Inc. — a variety, junior department store chain, operating 238 stores in the southeast. In 1982 Rose's posted record profits of $11.56 million on sales of $661.9 million.

Sharing

Profits, losses, and cash distributions will be allocated:

Limited Partners	99%
General Partner	1%

The Transaction



NPA manages the properties and makes lease payments to the Partnership.

NPA (or an affiliate) purchases the properties and sells them to the Pension Group composed of pension and profit-sharing trusts. The Pension Group then sells the properties to the Partnership.

The Partnership leases back the properties to NPA. This "Master Lease" is for a term of 35 years — which corresponds to the term of the Partnership's mortgage obligations.

An affiliate of NPA will be responsible for managing and maintaining the properties.

The General Partner, Sponsor and its affiliates will receive substantial compensation in connection with the offering of the Units and the operation of the Partnership. (See "Compensation to the General Partner, Sponsor and Affiliates" in the Private Placement Memorandum.)

Broker-Dealer Information

Commissions

10% of Investor Capital Contributions payable in three installments over approximately two years from closing ($18,480 per Unit).

Suitability

The federal securities laws and the securities laws of certain states provide that purchasers of Units must meet certain suitability standards.

No person will be sold Units unless the General Partner believes that

1. The person is an accredited investor by reason of his satisfying one of the following tests:
    a. The investor had an annual income in excess of $200,000 in 1981 and 1982 and has a reasonable expectation of an annual income in excess of $200,000 in 1983.
    b. The investor has a net worth of $1,000,000.
    c. The investor purchases 1½ or more Units and the purchase price does not exceed 20% of the investor's net worth, or
2. The person has a net worth (exclusive of home, home furnishings, and automobiles) in excess of $150,000 for each Unit subscribed for ($100,000 for a fractional unit), is in the 50% federal tax bracket, and the investor (together with his purchaser representative, if any) has such knowledge and experience in financial and business matters as to be capable of evaluating the merits and risks of investing in the Partnership.

Notwithstanding the foregoing, any California resident desiring to purchase one Unit or a fractional Unit must have a net worth of not less than $300,000 (exclusive of home, home furnishings and automobiles).

Communications

Acceptance Letter
Audited Financial Statements
Tax Information (Schedules K-1)
Annual Property Reports

Key Features

Tax Benefits

- Immediate return of investment through tax savings
- 2.8 to 1 write-off ratio over the contribution period; 4.95 to 1 over the 15-year loss term
- Capital gains treatment at sale
- No recapture or tax preference items

Economic Benefits

- Long-term, predictable cash flow
- Capital appreciation
- 99%-1% sharing; no increased participation in favor of the General Partner upon sale or refinancing

Investment Protection

- Involvement with a quality, experienced sponsor; NPA is ranked as the nation's #1 developer of open shopping centers
- Leases with major high-credit tenants
- Financing is non-recourse to the Limited Partners

If this offering closes in October rather than November, as projected, those investors who are Limited Partners in October will realize a greater tax loss than that projected in Exhibit "A" due to the fact that the additional depreciation and interest expenses shall exceed the rental income received for that month.

Summary of Bluefield Associates

Projected Taxable Income (Loss) For One Unit Investment

Year	**Capital Contribution**	**Taxable Income (Loss)**	**Loss Ratio**	**Cash Flow**
1983 (2 months)	$ -0-	$ (18,152)	N/A	$ -0-
1984	30,800	(86,545)	2.81	-0-
1985	30,800	(86,879)	2.82	707
1986	30,800	(87,882)	2.85	1,061
1987	30,800	(83,689)	2.72	1,414
1988	30,800	(84,618)	2.75	1,768
1989	30,800	(71,513)	2.32	2,121
1990		(56,383)		2,121
1991		(55,263)		2,121
1992		(54,144)		2,121
1993		(45,953)		2,121
1994		(44,833)		2,121
1995		(43,714)		2,121
1996		(34,639)		2,121
1997		(33,270)		2,121
1998		(27,633)		2,121
Subtotal	**$184,800**	**$(915,110)**	**4.95**	**$26,160**
1999		1,919		2,121
2000		3,499		2,121
2001		5,080		2,121
2002		14,881		2,121
2003		16,461		2,121
2004		18,292		2,121
2005		26,116		2,121
2006		28,567		2,121
2007		30,608		2,121
2008		41,489		2,121
2009		43,530		2,121
2010		45,577		2,121
2011		57,715		2,121
2012		62,577		2,121
2013		64,539		2,121
2014		72,689		2,121
2015		74,651		2,121
2016		76,613		2,121
2017		84,763		2,121
2018 (10 months)		72,085		1,729
Total		**$(73,459)**		**$68,188**

THIS INFORMATION IS EXCERPTED FROM THE PRIVATE PLACEMENT MEMORANDUM.
FOR FULL DETAILS ON THIS OFFERING, SEE THE PRIVATE PLACEMENT MEMORANDUM.

[1] Does not include interest of 8% on these payments. Interest on limited partner's note per unit will be $7,496 per annum for 1984-1989.

[2] Cash flow may be supplemented by the sharing agreement with the Sponsor regarding rents paid under the K mart lease in the Bluefield Plaza and, additionally, commencing in 1993 by the sharing arrangement with the Sponsor regarding rents paid under the Tenant leases.

Kmart
auto service

Bluefield Plaza, Bluefield, West Virginia

Newmarket Shopping Center, Ahoskie, North Carolina

For further information, contact:

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National Property Analysts, Inc.

October 14, 1983

BLUEFIELD ASSOCIATES

There is sufficient pressure from within the brokerage community to close this offering within the next three weeks. There will be a preliminary close October 28.

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Sales Points:

1. No cash in 1983, no payment until February.
2. 5:1 write off.
3. 10% commission, fully paid by January of 1985.
4. Largest and most experienced syndicator in the nation.
5. Extensive and successful audit history.
6. In-house property management of 13,000,000 square feet of quality centers.

Call today to indicate active interests.

Arthur W. Lenhardt
Regional Marketing Manager

Mr. GIBBONS. Thank you, gentlemen. I am sorry you are all going broke.

OK, let us see, who are the next set of witnesses?

We have Sazerac, Heublein, David Sherman, and Serralles Distillery. We understand that Mr. Lux has been snowed in someplace.

Mr. Bordeaux, you will be first; Mr. McGarry second.

All right, Mr. Bordeaux, we will hear from you first.

STATEMENT OF P. W. H. BORDEAUX, PRESIDENT, SAZERAC CO., INC., ACCOMPANIED BY STANLEY SCHWAM, VICE PRESIDENT, SAZERAC CO., INC., AND CHAIRMAN OF THE BOARD, AMERICAN BEVERAGE ALCOHOL ASSOCIATION

Mr. BORDEAUX. My name is Peter Bordeaux. I am president of the Sazerac Co. I am going to offer a short statement at this time.

We have presented a formal statement of our company to be submitted to the record.

Alongside of me is Stanley Schwam, who is vice president of Sazerac and chairman of the board of the American Beverage Alcohol Association, which is a prominent wine and spirits trade group that represents the smaller producers and suppliers in this country.

We are here today in support of H.R. 4702 with its present effective date of January 31, 1984, for the closing of this redistillation program.

Sazerac is an importer, bottler, and marketer of beverage alcohol products, and we are based in New Orleans, La. Sazerac sells across the United States and in several foreign countries. Sazerac produces one of the top 10 selling vodkas in the United States—Taaka vodka; and one of the top 10 tequilas—Torado tequila. Sazerac also imports the No. 4 selling imported vodka—Wyborowa, from Poland.

Sazerac is a privately owned, independent company, and we are part of the second tier of suppliers that compete in the marketplace. We are extremely sympathetic to the budget needs of Puerto Rico and the financial problems of the distiller in Puerto Rico. However, in the redistribution program is allowed to continue in its present form, in a program that has no economic viability and is also highly anticompetitive, our position in the marketplace is highly threatened.

We believe that if Puerto Rico needs tax revenues, and we do not doubt that they do need these revenues, that Congress should consider an appropriation to help out the Puerto Rican economy.

I will be available for any other further questions.

Mr. GIBBONS. Thank you.

Our next witness is Mr. McGarry.

[The prepared statement follows:]

STATEMENT OF P. W. H. BORDEAUX, PRESIDENT, SAZERAC CO., INC.

SUMMARY

The Economic Development Administration of Puerto Rico (Fomento) developed a program for the redistillation in Puerto Rico of "Light Whiskey Designate" or "Corn Whiskey" that is later shipped to the United States as neutral grain spirits (NGS) for use as vodka, gin, cordials, etc.

Under 26 USC 7652, if this product qualified as a "Product of Puerto Rico", the Federal excise tax of $10.50 per proof gallon does not go to the United State Treasury, but "Covers over" to the Puerto Rican Treasury.

According to Fomento, a portion of the $10.50 a proof gallon, at least $2.00, is being "kick-backed" to certain Puerto Rican distillers and their United States counterparts.

Due to the irrational limitation placed on this program, Sazerac and many other suppliers have not been allowed to participate and a truly anticompetitive situation has developed.

Originally, Fomento stated to the Bureau of Alcohol, Tobacco, and Firearms (BATF) that the program was to process approximately 5 million proof gallons per year or about 8 percent of the total neutral grain spirits used in the United States. During fiscal year 1985, Fomento admits that the program will redistill about 23 million proof gallons, 39 percent of the total neutral grain spirits in the United States and will cover over about 250 million dollars of the Federal excise tax to Puerto Rico.

Instead of cautiously continuing with the redistillation program, Fomento upon notification of H.R. 4702, dramatically increased the amount of redistilled spirits entering the United States.

Due to Fomento's refusal to present BATF with all the necessary facts, equitable reliance in this case does not apply for Fomento, Puerto Rican distillers, or their United States counterparts.

At present, rum distillers in Puerto Rico and the Virgin Islands receive a substantial subsidy from the over 200 million dollars covered over to Puerto Rico and the Virgin Islands under 7652. As part of the Caribbean Basin Initiative, all Federal excise tax on any rum from outside of Puerto Rico and Virgin Islands shipped to the United States is also covered over to Puerto Rico and the Virgin Islands.

If Fomento wants to continue with this program, covered revenue to Puerto Rico should be allowed only on original distillation and the market opportunities and "incentives" should be available to all United States producers.

Although Fomento has been the major government agency involved, the Virgin Islands have the same opportunity and the redistillation program should be closed to this area as well.

STATEMENT

Mr. Chairman: I am Pierre Bordeaux, president of the Sazerac Company, Inc. Alongside of me is Stanley Schwam, vice president of Sazerac and chairman of the board of the American Beverage Alcohol Association, a prominent wine and spirits trade organization. We are here in support of H.R. 4702 with its present effective date of 31 January 1984, and for the requiring of original distillation of beverage alcohol to occur in Puerto Rico and the Virgin Islands in order for 26 U.S.C. 7652 to allow the covering over of the Federal excise tax.

INTRODUCTION

Sazerac is a producer, importer, bottler and marketer of beverage alcohol products based in New Orleans, Louisiana. Sazerac sells products in all 50 States and in several foreign countries. Sazerac is primarily a "white" goods company with our dominant product lines being vodka, gin, and tequila. Sazerac produces one of the top ten selling vodkas in the United States—Taaka; and one of the top ten selling tequilas—Torada; and imports the No. 4 selling imported vodka—Wyborowa, from Poland. Every year Sazerac purchases more than 2-million proof gallons of Neutral grain spirits (NGS). Sazerac employs about 150 people and is part of a group of smaller, independently owned suppliers that compete against the large multi-national producers, including: Seagram's, Heublein, IDV-Grand Met, Brown-Forman, Schenley, Fleischman-Wile, National Distillers, Bacardi, etc. Since the end of prohibition, over 200 suppliers have gone out of business or have been bought-out by foreign interests or larger companies. This is due in part to the very competitive nature of the liquor industry coupled with a relatively low or no growth experience. At present there are only a handful of independent producers left in the United States.

PUERTO RICO REDISTILLATION

For several years, the Economic Development Administration of Puerto Rico (Fomento), in an attempt to increase the amount of Federal monies going to Puerto Rico, sought a procedure for importing United States distilled alcohol and redistilling the product in Puerto Rico, returning the product to the United States as neutral grain spirits and reclassifying it as a product of Puerto Rico. Such a scheme allows for the Federal excise tax of $10.50 per proof gallon to be "covered over" to the Puerto Rican treasury as allowed under 26 U.S.C. 7652.

It is well documented that the United States has been consistently interested in aiding the development of Puerto Rico's industrial base. The covering over of revenue from spirits distilled in Puerto Rico has existed since right before World War I. The first statute, which provided for the covering over of taxes collected on products manufactured in Puerto Rico [Jones Act, sec. 9, 39 stat. 951 (1917)], states that the covering over is allowed only on Puerto Rican products. This statute, when read in conjunction with *Anheuser-Bush Brewing Association* v. *U.S.* 207 U.S. 556 (1908), provides that in order for a product to be considered Puerto Rican it must be ". . . a new and different article." Therefore, a car manufactured in Europe without tires on it, shipped to Puerto Rico to have the tires put on it and then shipped to the United States, would not be a car of Puerto Rican origin. However, if shoe soles from one location and shoe tops from another were shipped to Puerto Rico, and the heels and laces were manufactued in Puerto Rico and the Product was sewn in Puerto Rico and boxed in Puerto Rico and delivered to the United States, the shoes would be considered a product of Puerto Rico. In the Puerto Rican redistillation program, potable alcohol produced in the United States is shipped to Puerto Rico and redistilled into potable alcohol and then shipped to the United States as potable alcohol, without a transformation or a new "distinctive . . . use" (see *Anheuser, et al*).

HOW DOES THE REDISTILLATION PROGRAM WORK

The redistillation process in Puerto Rico is nothing more than a purification process to remove some congeners and water which were purposely left in the spirits during the original distillation to qualify the spirits under the BATF guidelines as manufactured in Puerto Rico.

Appendix 1, Route 1 shows the normal movement of neutral grain spirits to a producer involved in the Puerto Rican redistillation program. The product is produced in the Midwest and shipped by rail to the east coast. Route 2 is the movement of product for Puerto Rican redistillation. In the case of route 2, either light whiskey designate or corn whiskey is produced in the Midwest, shipped to a port for loading on a container ship to Puerto Rico, trucked to the Puerto Rican distiller for redistillation, then trucked back to a vessel and shipped to the east coast of the United States, and finally hauled to the site of processing and bottling. One can easily detect the large amount of wasted energy and transportation involved.

Exhibit A shows the cost of neutral grain spirits under normal circumstances from the Midwest to the east coast. Exhibit B shows an estimated cost of the neutral grain spirits under the Puerto Rican redistillation program.

This program would not be feasible except that the United States Treasury covers over the $10.50 a proof gallon tax to the Puerto Rican Government for each proof gallon imported from Puerto Rico to the United States. Out of the $10.50, the Puerto Rican Government is rebating at least $2.00 per gallon to the Puerto Rican distiller. A portion of this rebate, $1.50, is used against expenses and the remaining $.50 is a so-called "incentive". This $2.00 kick-back is a significant problem for the non-participants and an unfair advantage to the United States producers involved.

Exhibit C indicates the normal cost of neutral grain spirits of $1.02 per gallon. If the $.50 incentive is split evenly between the United States producer and the Puerto Rican distiller, then the cost of neutral grain spirits is $.24 per gallon as indicated in exhibit D, resulting in a $.78 price advantage per proof gallon for the United States producer.

Exhibit A

NGS	$0.88
Freight	.14
Total	1.02

Exhibit B

Light whiskey designate/corn whiskey	$0.88
Freight, shipping, etc	.81
Redistillation	.30
Total	1.99

Increase cost for redistillation: $.97.

Exhibit C

$0.88
.14
1.02

Exhibit D

Light whiskey designate	$0.88
Freight	.81
Redistillation	.30
Total	1.99
Cost kickback	−1.50
	.49
½ of "incentive"	−.25
	.24
Savings per proof gallon	.78

ANALYSIS OF PROBLEMS

The movement of alcohol through Puerto Rico, for the purpose of covering over the $10.50 a proof gallon Federal excise tax, is economically perverse for several reasons:

(1) Fomento admits that the scheme is only economically viable for the U.S. participants because it is rebating at least $2.00 per proof gallon to the Puerto Rican distillers and these distillers are then "kicking-back" a large portion of that rebate to their United States counterparts.

(2) The kickbacks significantly lower the cost of neutral grain spirits for the few U.S. participants and markedly improve the competitive position of these producers. Fomento, Puerto Rican distillers, and U.S. participants have given evidence to the fact that the program has a limited, intentionally restricted, number of participants even though the rebate lowers the cost of a commodity used in interstate commerce. And while it affects a significant portion of the national supply of neutral grain spirits, it is not available on an equal basis to all users of the commodity.

(3) The source of the rebate to the producers is not from local tax revenues, but from a Federal excise tax that is the dominant component of the price of all liquor sold in the United States.

(4) The Puerto Rican rebate does not serve any valid Puerto Rican purpose or need. It simply is an inducement in its subterfuge to take Federal excise tax from the United States Treasury and cover over to the Puerto Rican Treasury the tax without the consent and advice of the Congress or the administrations. This program operates at the expense of the United States Treasury and the mainland based producers who are not participating.

(5) The Puerto Rican Redistillation program sought approval from the Bureau of Alcohol, Tobacco and Firearms (BATF) without offering for review a significant number of very pertinent facts including that a kickback to United States participants existed; the amount of or knowledge of any local incentive to Puerto Rican distillers; and the total amount of neutral grain spirits to be used in the program (Fomento told BATF 5-million proof gallons, actual amount in excess of 20-million proof gallons). Therefore, a cry of "good-faith" reliance must be looked upon with jaundiced observation.

(6) The United States participants are using the financial benefits of this program to take advantage of other companies in the market in an anti-competitive manner.

TAX REVENUE LOSS

The Puerto Rican redistillation program will cost the United States Treasury 250 million tax dollars per year. This comes on top of a loss to the United States Treasury of Federal excise tax receipts of 200 million tax dollars per year due to the 1979 bicycle parts treaty. As a result of those negotiations, Congress changed the method of taxation on imported beverage alcohol from wine gallons to proof gallons. The combination of these two programs will result in the loss of more than one-half billion tax dollars in fiscal year 1985. This loss comes at a time when the United

States is having record deficits and when there is strong interest in increasing the Federal excise tax on beverage alcohol; a tax increase that could result in the bankruptcies of several more independent liquor suppliers due to lost sales because of the reduction in consumption.

INDUSTRY CONCERNS

The Puerto Rico distillation program is extremely anticompetitive. A $.78 savings equals about $1.49 per case of 750ml vodka. In a business where many producers make between $.75 and $1.25 per case of 750ml vodka, an additional $1.49 per case profit is a 149 percent increase. When the $.78 is multiplied by the estimated 23 million proof gallons processed, the result is an additional 18 million dollars in total profit. That additional profit can be used by the United States producers involved, for predatory prices, sales promotion, exclusionary practices, advertising, point of purchase, new plant, and equipment. This additional profit does not come from a new technological advance or efficiency, but from a tax loophole. This program, which has been restricted by intentional action, could put all of those not involved in the program out of business.

ANALYSIS OF QUESTIONS OF EQUITY

Officials of Fomento, Puerto Rico distillers, and their United States counterparts stated they entered into the redistillation program in "good faith" with the approval of the BATF.

As a matter of fact, BATF was unaware of the size of the program and the "incentives" involved, especially kickbacks to United States companies. BATF on several occasions requested information on the program from Fomento and these requests went unanswered (see appendices 2–8).

Since the introduction of H.R. 4702 with its effective date of 31 January 1984, Fomento, instead of cautiously proceeding with the program, has expanded the size and opened the "flood gates" for redistilled spirits to the United States in order to cover over as much Federal excise tax as possible.

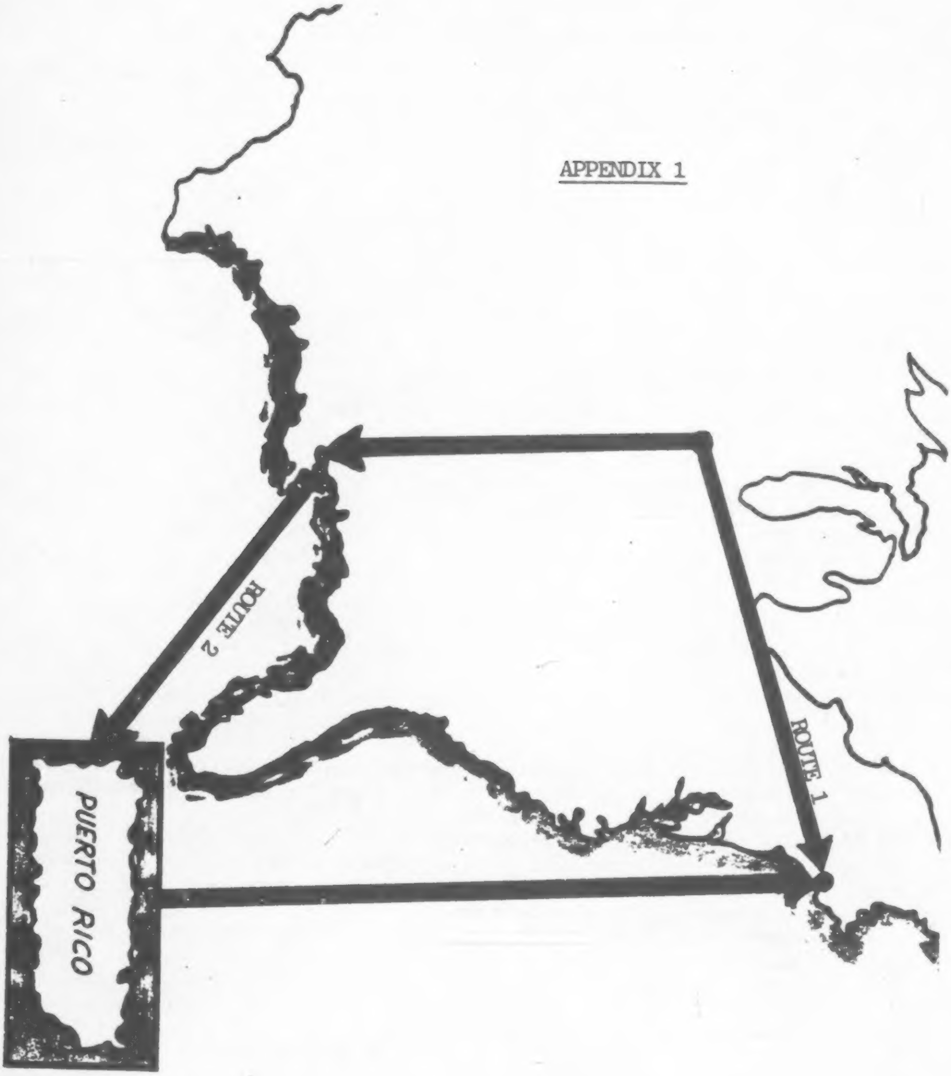
The beverage alcohol industry is regulated by over 300 separate jurisdictions. These jurisdictions are constantly promulgating new rules. In this case, a closing of the present loophole will no doubt cause some hardship on the budget of Puerto Rico. But if allowed to continue at the present rate for a period of transition, it is expected that nearly 40 percent of the neutral grain spirits used in the United States will be redistilled in Puerto Rico. This will result in 20 million dollars extra profit for those lucky enough to participate. If H.R. 4702 is not passed, the hardship will befall our company, companies in similar positions, and hundreds of employees who will have to be terminated due to lost sales.

CONCLUSIONS

This program is the result of an over-zealous Puerto Rican Economic Development Agency. Instead of developing the tax loopholes and looking for ways to appropriate United States tax dollars, Fomento should be contacting companies, such as Sazerac, promoting the advantages of developing businesses and investments in Puerto Rico.

Sazerac urges Congress to pass H.R. 4702 with its present effective date of 31 January 1984, and to require original distillation of beverage alcohol in Puerto Rico in order for the covering over of Federal excise tax under 26 U.S.C. 7652.

APPENDIX 1


ROUTE 2
ROUTE 1
PUERTO RICO

APPENDIX 2

SUMMARY OF PUERTO RICAN DISTILLATION PROGRAM

Late in 1981 Fomento (Economic Development Administration) requested an opinion on the treatment of grain neutral spirits imported into Puerto Rico from the United States and then returned to the United States as vodka. EDA's proposal projected removal of essentially 100% of the esters and aldehydes from the grain alcohol received from the United States. The final product would be neutral spirits grain which would meet the standard of identity of vodka. The spirits would then be classified as a product of Puerto Rico for tax purposes under 26 U.S.C. 7652.

Chief Counsel wrote an opinion on this proposal January 4, 1982, which established the principle of substantial change. In this opinion Counsel noted that if neutral spirits were received and redistilled, and vodka or NSG was the result, that a substantial change would not have occurred. The opinion further stated that if gin were produced in Puerto Rico from the United States spirits they would qualify as products of Puerto Rico having undergone a substantial change.

A letter to the EDA, dated January 12, 1982, gave them the information from Counsel's opinion. The letter reiterated the "essentially 100% removal of esters and aldehydes" proposal. Another letter from Bureau dated March 3, 1982, repeated the above information, including an explanation of the FAAA labeling requirements which would allow "Produced By" on the label when vodka was the end product of the redistillation. The letter stated specifically that if the plan to remove essentially 100% of the esters and aldehydes was followed, the spirits so processed (NSG–vodka) would be considered as having undergone a substantial change and would qualify as products of Puerto Rico.

On May 7, 1982 ——— sent a letter to the Department of Revenue to explain the redistillation process. Under ——— plan NSG would be shipped to Puerto Rico, redistilled an returned to the United States "basically no different than that originally shipped out"

Another letter dated June 18, 1982, was sent to EDA to clarify the March letter. The letter informed EDA that just any treatment, i.e. raising proof 1 or 2 degrees would ot qualify spirits a a product of Puerto Rico.

On June 29, 1983, the Bureau sent a memorandum to Main Treasury (Assistant Secretary for Enforcement and Operations) informing Treasury of the possible tax problems and enclosing copies of the letters to EDA.

On September 10, 1982, Bureau replied to a letter from the in Puerto Rico ——— in which ——— requested confirmation that redistilling NSG(190°) to make vodka was substantial change. The Bureau again replied that essentially 100% of esters and aldehydes must be removed as proposed by the EDA and that the Bureau must also have samples to analyze before committing itself to agreeing that a substantial change had taken place.

Several samples, comparing before redistallation and after redistallation products, were analyzed by the National Laboratory using the gas chromatagraph process. None of the samples (October 22, 1982, January 5, 1983, January 18, 1983, February 9, 1983, May 6, 1983) showed evidence of a substantial change. The before samples were all NSG and above 190° in proof. The after samples showed some reductions in high alcohols but little change in esters. Aldehydes were not detected in either the before or after samples. A memorandum from Chief Counsel, dated Febuary 28, 1983, supported our opinion that there was no substantial change. Letters, dated March 4, 1983, were sent to ——— notifying them that the processed spirits did not qualify as products of Puerto Rico. Discontinued sending NSG to Puerto Rico on March 7, 1983. Representing was notified by letter, dated April 22, 1983.

In the meantime the ruling itself was prepared and reviewed. A draft ruling was prepared and forwarded to Counsel for review. On March 21, 1983, Counsel, using a Regulations and Procedures draft ruling, prepared a more formal concurence within ATF the ruling was signed by the Director on May 9, 1983. Copies of the ruling were forwarded on May 24, 1983, to all RRA's.

In the meantime Regulations and Procedures Divison was working with ——— to develop a procedure to be followed using light whisky designated as the spirits exported to Puerto Rico. The procedure was developed and sent to ——— on April 11, 1983 and to ——— on May 27, 1983. Additional information on samples and records were forwarded to ——— on June 2, 1983 and to ——— on June 8, 1983. Had also expressed in an interest in using corn whisky for the redistillation program. A memorandum dated June 10, 1983, was sent to NAR requesting that the region establish an inspection program with regard to this program.

Another procedure which was developed during this period was related to providing information to the Puerto Rican government with copies of the reports (ATF Form 5110.28) filed by the DSP's with the amounts of Puerto Rican Spirits reported as received into the DSP processing accounts. In addition the Bureau is providing a separate report with entries showing "Rum Shipped in Bulk", "Neutral Spirits, Bulk" "Other Spirits, Bulk", "Bottled Rum" and "Total" to IRS.

Another item of interest is the exchange of correspondence between ——— and ATF with regard to the analysis procedures used in checking the samples. The National Laboratory uses the gas chromatograph method for alcohol. The laboratory for ——— is using titration or a spectrophotometric system. Claimed that the gas chromotograp was not an AOAC approved method for determining whether aldehydes and esters are present. The National Laboratory agreed that the gas chromatograph was not AOAC approved for aldehydes but was approved for esters. At regulations and Procedures Division request, the National Laboratory retested some of the earlier samples for aldehydes using AOAC approved method and found very small amounts (1.5 grams per 100 liters) of aldehydes where the gas chromatograph indicated aldehydes as undetected. The National Laboratory still avers that the gas chromatograph is the best system to use in testing alcohols. Should a court case develop with regard to whether or not there was essential 100% removal of aldehydes and esters, there would certainly be a disput as to the best and/or most accurate method for determining the presence of aldehydes and esters in the samples.

Some additional items of interest are:

(1) Senator Chiles of Florida requested information about the ruling and asked that we investigate a complaint from one of his constituents that one of the larger American distilleries was planning to ship citrus molasses to Puerto Rico where it would be distilled and returned to the United States as Residue Neutral Spirits Brandy. We found no basis for the complaint. The Senator also asked if there were any restrictions on the funds covered to Puerto Rico. There are none under 26 USC 7652.

(2) Through April 1, 1983 approximately $35,000,000 was covered to the Puerto Rican Treasury for the neutral grain spirits processed using the information and standards established by the Ruling Branch letters of March and June, 1982. It is Regulations and Procedures Division opinion that the standards were not met.

(3) ATF requested information regarding the Puerto Rican government's participation in the program. The request went to John Newton, Assistant Secretary, Economic Affairs, Department of Treasury, Puerto Rico. On March 4, 1983 we received a letter from Mr. Newton telling us that our request had been forwarded to the EDA. Despite several inquiries by the CPRO we have not received any information to date.

APPENDIX 3

DEPARTMENT OF THE TREASURY,
BUREAU OF ALCOHOL, TOBACCO AND FIREARMS,
New York, N.Y., March 4, 1982.

Memorandum to: Chief Ruling Branch.
From: Regional Regulatory Administrator North Atlantic Region.
Subject: "Purification" of Domestic Spirits by Puerto Rican Concerns.

The attached correspondance relates to a proposal by a Puerto Rican concern to "purify" or "redistill" alcohol. In essence ——— a Puerto Rican rectifier, wants to receive, presumably without payment of tax, 189 proof spirits from ——— in the United States. Upon receipt in Puerto Rico, ——— would "redistill" the NSG to a proof of 191 or 192. The NSG would then be shipped back to the United States for processing and bottling presumably as vodka. The basic question ——— is asking is whether they can perform this operation with their rectifier's permit.

There is, however, a greater more sensitive issue in this request. As a result of a meeting with Chief, Puerto Rico Operations the Bureau has learned that FOMENTO (Puerto Rico Industrial Development Corp., an entity of the Commonwealth of Puerto Rico) will reimburse ——— per proof gallon to perform this operation on approximately ——— proof gallons of NSG annually.

We have reason to believe that this is being done so that the spirits qualify as being of Puerto Rican manufacture. By so doing, the excise taxes collected would revert back to the government of Puerto Rico. The initial revenue loss to the United States, not considering any future losses, would be substantial.

We also understand that FORMENTO may be approaching other firms in Puerto Rico with a similar proposal.

Our questions are can this be done legally; and can we or do we want to discourage this type of operation?

If you have any questions regarding this matter please contact Art Libertucci at 264-2106.

DONALD C. MACVEAN.

APPENDIX 4

JUNE 10, 1982.

Memorandum to: Regional Regulatory Administrator North-Atlantic Region.
From: Chief, Rulings Branch.
Subject: Purification of Domestic Spirits by Puerto Rican Concerns.

This refers to your memorandum of March 4, 1982, requesting our advice on whether (1) the redistillation of U.S. produced spirits may be performed in Puerto Rico as a rectifying operation under a qualified firm's rectifier's basic permit and (2) the redistillation of such spirits qualifies as an act of Puerto Rican manufacture for the purposes of 26 U.S.C. 7652.

With respect to the first question, the redistillation operations are not authorized under the terms of the rectifier's basic permit. A basic permit as a distiller is necessary. Under the FAAA, any act of distillation, whether it be original distillation of spirits or redistillation of previously produced spirits, must be done pursuant to a distiller's basic permit.

With respect to the second question, the answer is not so clear cut. Since the material you submitted to us left some doubt as to the proof and designation of the spirits to be shipped to Puerto Rico and just what operations would be done in Puerto Rico, we contacted personnel in your Puerto Rico Operations office and were told the following:

(1) The spirits shipped from the U.S. would definitely be less than 190 degrees of proof but we are still unsure of the designation of the spirits (under FAAA standards, they would not be entitled to NSG or alcohol designations but would be entitled to certain whisky designations).

(2) The spirits will be increased in proof by redistillation from approximately 187 to 198 degree of proof to approximately 191 to 192 degrees of proof.

(3) After redistillation, the spirits will be filtered (possibly through charcoal) to further purify them.

(4) The product to be returned to the U.S. will be designated as vodka.

As you are probably aware, it is the Bureau's position that when distilled spirits originally produced in the United States are treated in Puerto Rico, the finished product will be considered to be one produced in Puerto Rico for 26 U.S.C. 7652 tax purposes if there has been a substantial change in the identity of the product. In this particular proposed operation it could be argued that there had been a substantial change in the identity of the product since the operation would entitle the spirits to a new designation—vodka.

However, on its surface the operation appears to be such a token treatment that we are not convinced that it should be entitled to be considered as a product of Puerto Rican manufacture for 26 U.S.C. 7652 purposes. Frankly, the proposed operation appears to be little more than a sham to tender tax revenues to the Puerto Rican Treasury which would otherwise be tendered to the United States Treasury. This seems to be the clear intent of the proposed operation since the redistillation operations will be subsidized by a Puerto Rican Government entity.

Earlier this year (see attached 3/3/82 letter) we advised the Puerto Rico Economic Development Administration that neutral spirits could be brought into Puerto Rico and redistilled into vodka with the resulting product (Vodka) being considered a product of Puerto Rican manufacturer for 26 U.S.C. 7652 purposes. However, in that particular situation the process did result in a substantial change as it contemplated removal of 100 percent of the esters and aldehydes present in the neutral spirits.

Notwithstanding the position taken in that letter, we are not prepared to state definitely that the finished product in the present case is entitled to be considered a product of Puerto Rican manufacture for 26 U.S.C. 7652 purposes. We believe that without specific evidence from the persons desiring to conduct the operations which shows that there will be a substantial change in the identity of the product (and possibly corroborating results of ATP laboratory tests), we should not advise the Puerto Rico concerns that the product will be considered to be one of Puerto Rican manufacture.

ROBERT E. DAUGHERTY.

Attachment.

APPENDIX 5

JUNE 29, 1982.

Memorandum to: Assistant Secretary (Enforcement and Operations).
From: Acting Director.
Subject: Redistillation of Spirits in Puerto Rico.

The purpose of this memorandum is to advise you of the bureau's position on a Puerto Rican Government plan to redistill U.S. produced spirits for the purpose of gaining the distilled spirits excise taxes under 26 U.S.C. 7652. Since the plan involves over $50 million in potential taxes and since Puerto Rican officials are being represented by local attorney K. Martin Worthy, former Chief Counsel of the Internal Revenue Service, the matter may become senstive.

Early this year we began to receive inquireis from the Puerto Rico Economic Development Administration (EDA) about the application of 26 U.S.C. 7652 to the redistillation of U.S. produced spirits in Puerto Rico for subsequent shipment back to the United States. We had advised EDA that the Bureau would consider distilled spirits treated in Puerto Rico as products of Puerto Rican manufacture for section 7652 purposes if the treatment resulted in a substantial change in the identity of the spirits. The excise tax on spirits of Puerto Rican manufacture shipped to the United States are covered into the Treasury of Puerto Rico.

Recently, EDA asked us whether grain alcohol produced in the United States could be redistilled in Puerto Rico so as to remove 100 percent of the esters and aldehydes, treated as necessary with charcoal, redesignated as vodka, and shipped back to the United States as a product of Puerto Rican manufacture. We advised them that, under that particular set of facts, the product would be considered one of Puerto Rican manufacture.

However, we have since come across information which leads us to believe that the operations being contemplated differ from what was presented to us by EDA.

Through our Puerto Rico Operations office, we have learned that the planned operations consist of little more than increasing the proof of 188-189 degree spirits, through redistillation, to 191-192 degrees of proof. We have also learned that FOMENTO (Puerto Rico Industrial Development Corporation—an entity of the Commonwealth of Puerto Rico) will subsidize Puerto Rican distillers $1.50 per proof gallon to perform this operation on approximately 5 million proof gallons annually. If this operation is allowed to occur, it will result in approximately $52.5 million per year, which otherwise would be covered into the U.S. Treasury, being covered into the Treasury of Puerto Rico under the provisions of 26 U.S.C 7652.

The nominal nature of the treatment, coupled with the Government subsidy, leads us to believe that the proposed activity is no more than a plan to divert tax revenues which rightfully belong to the U.S. Treasury.

On June 18, 1982, we forwarded a letter to EDA which advised them that token treatments of U.S. produced spirits in Puerto Rico would not entitle the spirits to be considered a product of Puerto Rican manufacture for tax purposes. We have also advised our regional offices to be alert to such operations. Where we find that spirits so treated are brought into the U.S. from Puerto Rico, we plan to withhold transferring ther taxes on those spirits to the Puerto Rican Treasury.

If any of your staff wishes to have more information on this matter, they may contact Robert Daugherty at 566-7531.

STEPHEN E. HIGGINS.

APPENDIX 6

Mr. JOHN R. NEWTON,
Assistant Secretary for Economic Affairs, Department of the Treasury, Commonwealth of Puerto Rico, San Juan, Puerto Rico.

DEAR MR. NEWTON: This letter refers to your letter of November 16, 1982 to the Director, Philadelphia Service Center concerning your request to include excise tax data on a new product to be shipped from Puerto Rico.

Beginning in January 1983 the report "Excise Taxes on Puerto Rican Products" prepared by the Philadelphia Service Center will have a neutral spirits category. The figure will include both neutral grain and neutral cane spirits as discussed with you by ATF Specialist Fred Roezler on December 6, 1982. In addition to that figure, Mr. Luis Deynes Reijoo (?) will receive copies of ATF Forms 5110.28 showing the amounts of neutral spirits received by individual DSP's in the United States. Mr. Deynes Reijoo should already have begun to receive these reports.

We are faced with a more difficult problem in determining whether or not the product—this incentives program qualifies for the tax under the provisions of 26

U.S.C. 7652. This particular section allows excise taxes to be returned to Puerto Rico if the neutral spirits are a product of Puerto Rican manufacture. Herein lies our difficulty. We have not been shown by the Economic Development Administration, Puerto Rico that there has been a substantial change between the product brought from the United States into Puerto Rico and the product returned to the United States. The Bureau Laboratory has tested one set of samples of the product and found essentially no differences, other than the name, between the incoming and outgoing products. We are currently waiting for another set of samples to be sent to the laboratory from Puerto Rico.

Two letters have been sent to Mr. Jose R. Madera, Economic Development Administration, Puerto Rico discussing this incentive program and the basic requirements for labeling the product as produced in Puerto Rico (copies of these letters are enclosed). Based on Mr. Madera's first description of the process to be used, we advised him on March 3, 1982 that the product could be considered as a product of Puerto Rico. After some further consideration we believed that the first letter may have caused Mr. Madera to believe that any processing of the neutral grain spirits would result in the spirits being considered a product of Puerto Rican manufacture for tax purposes. As a consequence, we wrote to Mr. Madera on July 18, 1982 to further clarify the operations or processes necessary to qualify the product under the provisions of 26 U.S.C. 7652. To reiterate one portion of that letter: "We have concluded that not all treatment operations which entitle a product to be labeled "produced by" the Puerto Rican distiller under Rev. Rul. 69-496 effect a substantial change in the identity of the neutral spirits." We further described one such operation, i.e. charcoal filtering which would allow the label, under the Federal Alcohol Administration Act, to show "produced by" but which does not make any substantial changes in the product thus making it ineligible under section 7652 of the I.R.C.

We cannot make a decision as to the product's eligibility under the provisions of 26 U.S.C. 7652 based on the information on hand. Therefore, we are asking distilleries in Puerto Rico to provide us with a complete statement of process to include the identity of the product shipped to Puerto Rico from the United States and its identity when leaving Puerto Rico as well as the distilling process itself. With that information and the Bureau Laboratory samples analyses we will be able to determine if there has been a substantial change in the identity of the product and therefore, qualify it for taxation (and attendent deposit of collections with the Puerto Rican Treasury) under 26 U.S.C. 7652.

We would also like to have more information on how this particular incentives program works. We have received bits and pieces of information, perhaps erroneous, which have not provided us with a clear understanding of the program. We would appreciate it if, at your convenience, you would provide us with information on the program such as, how long the program is scheduled to run, what type of products are involved, how much distilleries, both Puerto Rican and United States, and other participants are reimbursed, and the number of gallons of neutral spirits involved.

Should you have any other questions concerning this matter, please advise us.

Sincerely,

THOMAS GEORGE,
Chief, Regulations and Procedures Division.

Enclosures.

APPENDIX 7

DEPARTMENT OF THE TREASURY,
BUREAU OF ALCOHOL, TOBACCO AND FIREARMS,
Washington, D.C., March 17, 1983.

Memorandum to: All Regional Regulatory Administrators.
From: Chief, Regulations and Procedures.
Subject: Puerto Rico Redistillation Process.

The Bureau has been asked to determine if certain distilled spirits produced in the United States and then shipped to Puerto Rico for further distillation have undergone a substantial change so that the resulting spirits may be classified as a product of Puerto Rico. Products so designated will have taxes paid to the government of Puerto Rico rather than to the U.S. Treasury under the Provision of 26 USC (IRC) 7652(a). Chief, Counsel has prepared an opinion indicating that such spirits have not undergone a substantial change and are not products of Puerto Rico for tax purposes. A copy of the opinion is attached for your information.

In the opinion, Counsel has taken a clear stand on three items.

(1) Redistillation of NSG does not result in substantial change in the character of the NSG.

(2) NSG that is intentionally "muddied up" by ingredients that are easily removed by redistillation or filtration in Puerto Rico would not be considered to have undergone a substantial change.

(3) The treatment of NSG to produce vodka, although qualifying it as a product of Puerto Rico under the FAAA, does not constitute a substantial change for the purposes of tax credits under section 7652. In this case and others where a formula is required under 27 CFR Part 5 and a substantial change in the character of the spirits does not occur, ATF must approve the formula if it meets the provisions of Part 5. The formula can be overprinted with words to the effect that the product is subject to tax under 26 USC 5001 and not under 7652.

We are in the process of preparing a ruling defining substantial change. —— have been notified that the spirits currently being processed do not qualify as Puerto Rican products under the provisions of 26 USC 7652(a). The ruling, when published, will not be retroactive.

In the proposed ruling we have attempted to define substantial change as one that affects class, type, character and composition of the distilled spirits. Three specific processes were held not to constitute a substantial change.

(1) Neutral spirits produced from any material at 190 degrees proof or above at one location and then subjected to further distillation at another location are still neutral spirits.

(2) Distilled spirits produced from any material at less than 190 degrees of proof at one location and further distilled at another location without benefit of storage in oak cooperage between the two distillations would not be considered to have undergone substantial changes at the place of resumed distillation.

(3) Spirits distilled in the United States at more than 160 degrees of proof but at less than 190 degrees of proof which lack the taste, aroma and other characteristics of whiskey and which have been designated "Alcohol" or "Spirits" under the provisions of 27 CFR 19.597 and then further distilled in Puerto Rico will not be considered as having undergone substantial change.

We have also asked Counsel to consider the production of gin in Puerto Rico from the distilled spirits produced in the United States as a continuing process and not one of substantial change for the purpose of 26 USC 7652(a).

THOMAS GEORGE.

Attachment.

APPENDIX 8

U.S. SENATE, *July 22, 1983.*

Mr. STEPHEN E. HIGGINS,
Director, Regulations and Procedures Division, Bureau of Alcohol, Tobacco and Firearms, Department of the Treasury, Washington, D.C.

DEAR MR. HIGGINS: For your ready reference, I am enclosing copies of your letter dated June 22, 1983, Mr. Thomas George's letter dated April 11, 1983, and an April 17, 1983, BATF memorandum on the subject of the Puerto Rican distillation process.

Some confusion exists, based on the information contained in the materials listed above, of what constitutes a "product of Puerto Rico".

Specifically, (1) in Mr. George's April 11, 1983, letter, an exception is made in that the product does not have to be stored in oak copperage. In addition, the proof of the light whiskey designate is established at between 160 degrees and 170 degrees. In Mr. George's memo, (2) (second page), it is stated that distilled spirits produced from any material at less than 190 degrees "without benefit of storage in oak copperage" cannot be considered to have undergone substantial change.

It appears that BATF regulations are unclear on this issue and are possibly depriving the U.S. Treasury of current income and potentially greater income if the regulations are not made more restrictive. In addition, the economic harm caused small distillers who must compete with Puerto Rican distillers and other larger American companies who are selling a product that is not truly a Puerto Rican product at a cheaper price is a major concern to me.

As you address these issues, I will look forward to hearing from you.

With kindest regards, I am

Most sincerely,

LAWTON CHILES.

APPENDIX 9

AUGUST 16, 1983.

Hon. LAWTON CHILES,
U.S. Senate,
Washington, D.C.

DEAR SENATOR CHILES: This is in response to your request, dated July 22, 1983, that the Bureau of Alcohol, Tobacco and Firearms provide you with information regarding apparent confusion as to what constitutes a "product of Puerto Rico" for tax purposes under the provisions of 26 U.S.C. (IRC) 7652(a).

Your request poses two specific situations which appear to be in conflict and, for clarity, we will handle your questions in reverse order. The issue of Mr. George's memo of March 17, 1983, concerning "without benefit of storage in oak cooperage" was written as an informational memo to all ATF regional offices alerting them to a forthcoming ATF ruling which would prevent the transfer to Puerto Rico and token redistillation of essential neutral spirits.

Subsequent to that memo, the Bureau's National Laboratory, after samples were analyzed, advised us that grain spirits which were first distilled between 160° and 170° proof had the taste, aroma and characteristics attributed to Light Whiskey. The laboratory also advised us that these same spirits would undergo a substantial change when redistilled to 190° proof or above. Since the Light Whiskey Designate would undergo a substantial change by the removal of congeners in the redistillation, the redistilled neutral spirits would therefore qualify as a product of Puerto Rico under 26 U.S.C. 7652.

The second issue concerns permitting the product to be called Light Whiskey Designate. Although the spirits were never intended to be stored in our cooperage, the Bureau granted this variance from the regulations as a means of control over the production process in this country, over the receipt and redistillation in Puerto Rico, and the return of the spirits to the U.S.

We established this internal control system to trace and sample each batch before and after redistillation to assure us that the product has undergone a substantial change to qualify as a product of Puerto Rico under 25 U.S.C. 7652. Through this type of control we can prevent the meaningless redistillation of practically neutral spirits thus requiring as restrictive a process as possible under the provisions of the law.

The procedure of requiring the Light Whisky Designate designation requires the United States distillers to distill a product having significant amounts of congeners and the Puerto Rican distillers to redistill the congeners out creating a new product neutral alcohol or grain neutral spirits.

In providing the information to Puerto Rican and American distillers, we have attempted to interpret the laws and regulations governing distilled spirits as narrowly as possible using past precedents. The legislative history of Section 7652 does not contain any discussion of exactly what type of activity Congress would have considered sufficient to result in a product of Puerto Rico. It has been the opinion of the Bureau that Congress contemplated that the process involve some sort of significant treatment to make the item a product of Puerto Rico. With this in mind, the Bureau has adopted the substantial change criterion i.e., a change in class and type for distilled spirits. With the language of 25 U.S.C. 7652 as written and the fact that during redistillation the spirits do undergo a substantial change, the Bureau is not able to interpret the statute any more restrictively.

Currently, we do not have any positive information as to how the Puerto Rican government (Economic Development Administration) is using the tax moneys transferred to Puerto Rico. Our best available information has convinced us that the Economic Development Administration is using some of this money to subsidize the Puerto Rican distilleries who in turn make an arrangement with the United States distilleries. We have requested that we be provided such information, as you may have noted in our letter to Mr. John Newton. To date, we have not received any reply to our requests for more information although we have made three follow up visits to the EDA.

We trust that our reply has provided you with the information you requested.

Sincerely yours,

WILLIAM T. DRAKE,
Acting Director.

SAZERAC,
New Orleans, December 21, 1983.

Hon. NAME,
House of Representatives,
Washington, D.C.

DEAR CONGRESSMAN SALUTATION: The Federal Budget Deficit is reaching an all time high and there is constant debate on the need for additional taxes and their potential affect on the economy. However, there is a loop hole in the present tax law concerning distilled spirits that is costing the Federal Government tens of millions of taxpayers' dollars.

Presently, there is a law that allows liquor producers to circumvent the Federal Excise Tax on spirits by bringing to this country "neutral grain spirits" that have been processed and re-proofed in Puerto Rico from "light whiskey" distilled originally in the United States. The intent of the regulation was to foster development of industry in Puerto Rico by returning the Federal Excise Tax to Puerto Rico on liquor distilled there but sold in the United States, to assist their economy.

Using this loophole, however, the giant liquor companies are buying "light whiskey designate" in the United States, shipping it to Puerto Rico for redistillation to "neutral grain spirits" and then bringing that product back to the United States. The Federal Excise Tax on that product does not go to Washington, but to San Juan and the Puerto Rican government is then rebating the major portion of this Federal Excise Tax to the large liquor distillers to the detriment of the intent of the law and their competitors, who are not involved. Basically, this scheme is an evasion of the U.S. tax law to line the corporate coffers of the few at the expense of many instead of helping Puerto Rican industry and to provide tax dollars to the U.S. Treasury.

We ask you to protect this misappropriation of taxpayers' dollars by contacting the Secretary of Treasury and demand that the Bureau of Alcohol, Tobacco & Firearms end this loop hole immediately.

With best regards, I am
Sincerely,

P. W. H. BORDEAUX, *President.*

STATEMENT OF JOSEPH M. McGARRY, VICE PRESIDENT, CORPORATE AFFAIRS, HEUBLEIN, INC., ACCOMPANIED BY HAROLD GORMAN, VICE PRESIDENT AND GENERAL COUNSEL, HEUBLEIN SPIRITS CO.

Mr. McGARRY. My name is Joseph McGarry. I am vice president of the Heublein Co., which is headquartered in Farmington, Conn. On my left is Harold Gorman, who is vice president, general counsel, of the Heublein Spirits Co.

My testimony does regard H.R. 4072. It recounts the experience with the Serralles Distillery and the redistilling of light whiskey designate in Puerto Rico.

Contrary to the claims made that competitive advantages result to Heublein from this program, it shows that Heublein, indeed, is at financial and marketing risks, especially if the program were aborted. The beneficiaries of the redistilling program are primarily the Puerto Rican Government and, to a lesser degree, Puerto Rican distilleries.

I think it is important to note that since 1968, the Serralles Distillery in Puerto Rico has been a supplier of Don Q Rum brand to Heublein, which markets it in the United States.

In recent years, the Serralles Distillery has encountered difficulties which brought it to the brink of bankruptcy and necessitated stringent cost reductions, divestitures, and management changes.

To help the Serralles Distillery get itself out of its financial difficulty and to provide working capital for the start of its redistilling program, Heublein loaned the Serralles Distillery $5 million at a rate approximately 2 percent below prime, and secured by a supply of aging rum that is stored in Puerto Rico.

The loan and the advent of the redistilling program were critical to the survival of the Serralles Distillery and without them, the Serralles management told us, that the distillery could not survive.

By April 1983, the redistilling program, approved by BATF, allowed for light whiskey made in the United States to be sent to Puerto Rico for redistilling, and then sent back to the States for marketing.

Heublein sought confirmation from BATF at this time, and was reassured that light whiskey produced by suppliers in the Midwest and converted to grain neutral spirits in Puerto Rico under BATF terms would qualify for the Federal excise tax carryover.

So light whiskey made from midwestern grains is shipped from suppliers in Illinois, Iowa, and Kansas to the Serralles Distillery and redistilled there, and sent back to Heublein plants in Connecticut, Michigan, and California.

On arrival in the States, Heublein pays the going market price for the grain neutral spirits, just as if had been produced in the United States. Heublein uses the grain neutral spirits to make its beverage alcohol, and as this is shipped in to trade channels, Heublein pays the Federal excise tax of $10.50 per 100 proof gallon. The U.S. Treasury turns this over to the Puerto Rican Government, which pays the Serralles Distillery $2 per 100 proof gallon. The Serralles Distillery has reported its cost per proof gallon to be approximately $1.50.

Included in the Serralles Distillery cost is an administrative fee paid to Heublein that has ranged anywhere from 20 to 35 cents per proof gallon, which is intended to cover Heublein's cost of administering, brokering, and handling of the spirits.

The inference made in some public statements that Heublein receives as much as $2 per gallon completely erroneous. That payment of $2 is what goes to the Puerto Rican distiller.

If the redistilling program were to be curtailed before the Serralles Distillery gained sound financial footing and the distillery should go into bankruptcy, Heublein would stand to suffer the following losses: the loss of a portion or all of its $5 million loan, and the loss of the interest on that loan; the loss of outstanding receivables and fees which are currently more than $3 million, but which have been as much as $4½ million; the loss of an important supplier; and of the Don Q Rum brand in which Heublein has invested approximately $30 million in advertising, merchandising, selling, and administrative costs. The Don Q brand is owned by the Serralles Distillery.

That there would be other consequent losses as well, including the loss of perhaps $5 million of Federal and State income taxes and State liquor and sales taxes which are generated by our sales of Don Q brand.

In addition, there are labor and other business expenditures for packaging, freight, and so forth, associated with this brand, the sale of this brand, that add up to about $3 million annually. This, too, would be lost.

The charges by critics of the program that this gives U.S. spirits companies lower cost alcohol are unfounded, since the cost of the grain neutral spirits is at the going market rate. The small per-gallon administrative fee that is due Heublein is readily used up in the cost of administering the overhead of the program.

Why did Heublein enter into the program? Clearly, it is to help sustain an important supplier and a Heublein licensee in Puerto Rico. Heublein has a key marketing position to uphold as a full-line supplier of leading spirits brands, and Don Q Rum is important in that context.

As a full-line supplier, Heublein has greater importance to its wholesalers. The demise of the Don Q Rum brand would threaten that position and afford a greater opportunity for Heublein competitors to gain increased market shares.

In summary, Heublein entered the redistilling program, not for profit derived from fees, nor to gain competitive market advantages, but to sustain an important supplier, secure the supply of the Don Q brand, and maintain Heublein's position as a full-line supplier in the marketplace.

In consideration of the good faith and intent with which Heublein entered the program and the precaution that it took in securing confirmation from the U.S. Treasury in approving the program, Heublein has asked that the program be continued at the level that has been projected by Puerto Rico. Our hope would be through December 31 of 1986.

The significance of that date is that is the date by which the Serralles Distillery is scheduled to repay us the $5 million loan, and it is also expected that the Serralles Distillery, by that time, would be in a position to repay the loan because it should be on sounder financial footing.

Thank you very much.

Mr. GIBBONS. Thank you, sir.

[The prepared statement follows:]

STATEMENT OF JOSEPH M. MCGARRY, VICE PRESIDENT, CORPORATE AFFAIRS, HEUBLEIN, INC.

Mr. Chairman, Members of the Committee: My name is Joseph McGarry. I am Vice President, Corporate Affairs for the Heublein Company, headquartered in Farmington, Connecticut.

My testimony regards H.R. 4072, a bill to amend the Internal Revenue Code of 1954 to clarify the definition of articles provided in Puerto Rico for purposes of determining the amount of Federal internal revenue taxes which are paid over to Puerto Rico.

It recounts Heublein's experience with the Serralles Distillery in the redistilling of light whiskey designate in Puerto Rico.

Contrary to the claims made that financial gains and competitive advantages result to Heublein from this program, it shows that Heublein indeed, is at financial and marketing risks, especially if the program were aborted, the beneficiaries of the redistilling program are primarily the Puerto Rican Government and, to a lesser degree, Puerto Rican distilleries.

It is important to note that since 1968, the Serralles Distillery, in Puerto Rico, has been a supplier of Don Q rum to Heublein, which markets it in the U.S. In recent years, the Serralles Distillery has encountered difficulties which brought it to the brink of bankruptcy and necessitated stringent cost reductions, divestitutes and management changes.

To help the Serralles Distillery get itself out of its financial difficulties and to provide working capital for it to start-up its redistilling program, Heublein loaned Serralles $5 million at a rate approximately 2% below prime and secured by a supply of aging rum stored in Puerto Rico. The loan and the advent of the redistilling program were critical to the survival of the Serralles Distillery. Without them, the Serralles management concluded that the distillery could not survive.

By April of 1983, the redistilling program, approved by BATF, allowed for light whiskey made in the United States to be sent to Puerto Rico for redistilling and then sent back to the States for marketing.

Heublein sought confirmation from BATF at this time and was reassured that light whiskey produced by suppliers in the Midwest and converted to grain neutral spirits in Puerto Rico, under BATF terms, would qualify for the Federal excise tax carry-over.

So, light whiskey, made from Midwestern grains, is shipped from suppliers in Illinois, Iowa and Kansas to the Serralles Distillery, redistilled, and sent back to Heublein plants in Connecticut, Michigan, and California. On arrival in the States, Heublein pays the going market price for the grain neutral spirits, just as if the grain neutral spirits had been produced in the States.

Heublein uses the grain neutral spirits to make its beverage alcohol and, as this is shipped into trade channels, Heublein pays the Federal excise tax of $10.50 per 100 proof gallon. The U.S. Treasury turns this over to the Puerto Rican Government, which pays the Serralles Distillery $2.00 per 100 proof gallon. The Serralles Distillery has reported its cost per proof gallon to be approximately $1.50.

Included in the Serralles Distillery's costs is an administrative fee paid to Heublein that has ranged from 20 to 35 cents per gallon, which is intended to cover Heublein's costs of administering, brokering, and handling of the spirits. The inference made in some public statements that Heublein receives as much as $2.00 per gallon is completely erroneous. That payment goes to the Puerto Rican distiller.

If the redistilling program were to be curtailed before the Serralles Distillery regains sound financial footing, and the Distillery goes into bankruptcy, Heublein would stand to suffer the following losses:

Loss of a portion or all of its five million dollar loan and the loss of the interest on that loan.

The loss of outstanding receivables and fees which are currently more than $3 million, but which have been as high as $4.5 million.

The loss of an important supplier and of the Don Q rum brand in which Heublein has invested approximately $30 million in advertising, merchandising, selling and administrative costs. The Don Q brand is owned by Serralles.

There would be consequelt losses to others as well, including the loss of more than $5 million per year of Federal and State income taxes and State liquor and sales taxes which are generated by the brand. In addition, labor and other business expenditures for packaging, freight, etc., estimated at more than $3 million dollars annually, would be lost by suppliers.

The charges by critics of the program that this gives U.S. spirits companies lower cost alcohol are unfounded, since the landed cost of the grain neutral spirits is at the going market rate. The small per-gallon administrative fee due Heublein is readily used up in the cost of administering the program.

Why did Heublein enter this program?

Clearly, it is to help sustain an important supplier and a Heublein licensee in Puerto Rico.

Heublein has a key marketing position to uphold as a full-time supplier of leading spirits brands and Don Q rum is important in that context. As a full-line supplier, Heublein has greater importance to its wholesalers. The demise on Don Q rum brand would threaten that position and afford a greater opportunity for Heublein competitors to gain increased market shares.

In summary, Heublein entered the redistilling program, not for profit derived from fees nor to gain competitive market advantages, but to sustain an important supplier, secure the supply of the Don Q brand, and maintain Heublein's position as a full-line supplier.

In consideration of the good faith and intent with which Heublein entered this program, and the precaution taken in securing confirmation of the U.S. Treasury's approval of the program, Heublein asks that the program be continued at the level projected by Puerto Rico, at least through December 31, 1986, the date by which the Serralles Distillery is scheduled to repay the $5 million loan to Heublein. It is expected that the Serralles Distillery, by that time, will be on a sounder financial footing.

Mr. GIBBONS. We will put Mr. Lux's statement in the record at this point.

[The statement and attachment follow:]

[Mailgram]

David Sherman Corp.,
St. Louis, Mo., February 27, 1984.

Mr. John J. Salmon,
Chief Counsel, Committee on the Ways and Means,
Washington, D.C.

Gentlemen: This statement is being sent by wire because the weather has prevented me from attendance in person at your hearing. Please include this in the record of the hearings.

The purpose of this testimony is to express my concerns over the excise tax shuffling that is going on in Puerto Rico. This matter being currently the subject of your hearing as it relates H.R. 4702.

I first heard of this Puerto Rican scheme in July 1983, at which time I attempted to investigate the matter. I learned that the program apparently started early in 1983 when the Government of Puerto Rico set up a program with the approval of BATF to provide incentives for local rum producers to re-distill spirits imported into Puerto Rico from the U.S. mainland, and then re-exported back to the mainland for use in beverage products other than rum. This reprocessing qualified the $10.50 excise tax per U&S. proof gallon to accrue to Puerto Rico. I understand the program was primarily set up for a combined deal between Heublein and Serralles. I saw a report which indicated that Puerto Rico set up an initial fund of 8 million dollars to be paid at the rate of $1.50 per U.S. proof gallon re-processed. The intent of the arrangement was that the distiller would net $0.50 out of the $1.50 and the mainland partner in the deal would net something like $0.20 per U.S. proof gallon, I was told that Glenmore distillers set up a similar program with Trigo, a Puerto Rican distillery, that Bacardi was attempting to set something up and Segrams was investigating the matter.

Having learned this much I decided to attempt to work out a deal, as a defensive measure, because I realized that if the big distilleries were involved in this, the smaller producers would be further damaged unless we can take advantage of this loophole. I contacted two other large distilled spirits plant operators and asked them to join with me in this undertaking. They agreed, we understood that it was necessary to set up a partnership with the Puerto Rican distiller. Thus the 3 U.S. companies would form a joint venture with the distiller providing sufficient volume to interest the distiller in situation and that the only reason we were interested in it was from a defensive standpoint. We all agree that we did not feel this was the way that the tax law was supposed to be administered.

I was put in touch with a Puerto Rican lawyer by the name of Fred H. Martinez, and I was advised that Mr. Martinez was familiar with this re-distillation situation and that he would be able to handle the matter for us. I spoke on several occasions with Mr. Martinez, and he indicated that he would be in touch with the appropriate people and respond to our inquiry. Several weeks went by, and on September 26, 1983, he advised us, and I quote, "at this time it appears that the type of operation which you are contemplating would fall without the scope of possibility inasmuch as the Puerto Rican Government incentives would seem to have reached a level of complete saturation." In other words, he was in effect saying, "membership in the club is closed." I was advised in a later conversation with another party that the reason the matter was closed was because the Puerto Rican Government was very sensitive to this matter and did not want to see it get out of hand and become an issue, which it now is.

In any case, after having received word that we could not participate, I wrote to Mr. Steve Higgins, director of the BATF. In my letter to Mr. Higgins, I explained the situation and indicated our opposition to the program. I further indicated that while we were opposed to the program, if in fact the program was legal, then it should certainly be open to all licensees who have a distilled spirits plant permit, as we did not feel that the few companies involved here had any special privileges on their permit. Mr. Higgins wrote me back expressing understanding of our concern, but indicating there was nothing they could do about the matter, that they were studying certain legal interruptions and trying to resolve certain problems associated with the program.

In view of our lack of success with Mr. Martinez and with the BATF, I decided at that point just to let the matter rest because I did not feel that I alone, or even in conjunction with the two other companies that I had solicited, would be able to do much about this situation which was obviously tightly controlled by giant companies and governments.

In closing, I would like to say that we are definitely opposed to the current program that is going on in Puerto Rico concerning the redistillation of spirits, and we feel that this should be definitely stopped. I think it is really inconceivable that the Congress would even consider allowing this to continue in light of the financial needs in the United States. If you want to give Puerto Rico some additional funds, then pass a bill to do so, but please don't do it by letting a few big distillers reap extra profits at the expense of the entire industry. Let everyone pay their share to subsidize Puerto Rico if that's what must be done.

Thank you very much.

PAUL A. LUX,
President, David Sherman Corp.

DEPARTMENT OF THE TREASURY,
BUREAU OF ALCOHOL, TOBACCO AND FIREARMS,
Washington, D.C., March 2, 1976.

Mr. MANUEL MORALES VALLES,
Bureau of Alcoholic Beverages Taxes,
San Juan, P.R.

DEAR MR. VALLES: Our New York office has transmitted to us your letter of October 22, 1975, in which you ask for a determination as to whether under certain conditions distilled spirits would be considered products of Puerto Rico. Your letter presented for such determination four situations involving the treatment of distilled spirits in either the United States or Puerto Rico.

Before answering your questions, we believe it will be helpful to explain certain terms. We assume that the term "industrial distilled spirits", as used in your letter, refers to ethyl alcohol (distilled spirits) made from molasses or grain. Also, the term "rectification" means generally, an act of purifying or refining (such as redistillation) or an act of mixing (either with other kinds of spirits or with flavors, coloring, syrups, etc.) which results in a substantial change in the character of the spirits so treated. The mere reduction with water, and bottling in the United States, of distilled spirits produced in Puerto Rico, would not be recitification and would not make the distilled spirits a product of the United States. Conversely, the mere reduction with water, and bottling in Puerto Rico, of distilled spirits produced in the United States would not make the distilled spirits a product of Puerto Rico. The place of taxpayment or bottling of liquors is not important to the consideration of whether liquors are products of a particular country or territory, however, products which are rectified in a particular country or territory become products of that country or territory.

Your questions, as we understand them, and our answers to them are as follows:

(1) Would rum, vodka, gin or alcohol distilled in Puerto Rico and rectified and bottled in the United States be considered a product of Puerto Rico after the completion of such treatment,

No, such distilled spirits would be considered products of the United States as a result of their rectification in the United States.

(2) Would rum, vodka or gin produced in the United States and rectified and bottled in Puerto Rico be considered a product of Puerto Rico after such treatment?

Yes, such distilled spirits would be considered, products of Puerto Rico due to their rectification in Puerto Rico? Would Canadian whisky, Scotch whisky or bourbon whisky which is rectified and bottled in Puerto Rico be considered a product of Puerto Rico?

Such distilled spirits would be considered products of Puerto Rico due to their rectification in Puerto Rico. However, Canadian whisky, Scotch whisky and bourbon whiskey are distinctive products of Canada, Scotland and the United States, respectively. Consequently, by causing these distilled spirits to become products of Puerto Rico by rectification in Puerto Rico, such distilled spirits could no longer be called Canadian whisky, Scotch whisky or bourbon whisky under 27 CFR 5.22(b).

(4) If rye, bourbon, corn or light whisky were rectified in Puerto Rico by mixing with neutral spirits distilled in Puerto Rico, would the resultant product be considered a product of Puerto Rico?

Yes, the products resulting from such processing in Puerto Rico would be considered products of Puerto Rico since the mixing of different kinds of distilled spirits is an act of rectification. However, such whiskies could no longer be called, rye, bourbon, corn or light whisky under 27 CFR 5.22(b) after the addition of neutral spirits.

Enclosed for your information is a copy of ATF Publication 1, Regulations under the Federal Alcohol Administration Act, which contain in Part 5 the standards of identity for distilled spirits. Enclosed also is a copy of ATF Publication 19, Distilled

Spirits Plants, which contains those regulations regarding rectification referred to in this letter.

Copies of this letter will be sent to our Chief of Puerto Rican Operations in San Juan, Puerto Rico, and our regional office in New York.

Sincerely yours,

Earl P. Kernard
(For Ora J. Pierce, Acting
Assistant Director, Regulatory Enforcement).

Enclosures.

Commonwealth of Puerto Rico,
Economic Development Administration,
San Juan, P.R., April 13, 1981.

Mr. Michael J. La Perch,
Regional Director, Bureau of Alcohol, Tobacco and Firearms, Department of the Treasury, Bureau Headquarters, Washington, D.C.

Dear Mr. La Perch: As you surely know, Puerto Rico produces neutral distilled spirits from sugar cane molasses, which is the basis for one of the most important industries of Puerto Rico since it provides the greatest source of income for the Treasury of Puerto Rico.

Section 7652, Title 26 of the United States Code Annotated (USCA), provides that distilled spirits of Puerto Rican manufacture coming into the United States shall be subject to a tax equal to the internal revenue tax imposed by 26 USCA § 5001 and § 5022. It is further provided that all taxes collected on such distilled spirits shall be covered into the Treasury of Puerto Rico, subject to retention of the costs of administration, as provided in 26 USCA 5314(a)(4).

It is our understanding that distilled spirits should be considered a product of Puerto Rico if the final rectification of that spirits takes place within Puerto Rico. It is further understood that rectification means an act of purifying and rectifying, or an act of mixing which results in a substantial change in the character of the spirits so treated.

Your opinion is respectfully requested as to whether liqueurs or cocktails formulated or bottled in the United States with neutral cane distilled spirits produced in Puerto Rico would be considered a product of Puerto Rico for purposes of returning the excise taxes paid thereon to the Puerto Rican Treasury, as provided in USCA, Title 26, Section 7652(a)(3). These neutral cane spirits produced in Puerto Rico would be shipped in bulk to a designated bottler in the United States where they would be used as the primary finished ingredient in formulating liqueurs or cocktails. A suggested formulation for a liqueur is attached as Exhibits A and B.

It is our opinion that the Federal excise taxes paid on the liqueurs or cocktails so formulated would qualify to be covered into the Treasury of Puerto Rico. Our opinion is based on the fact that neutral cane distilled spirits are of Puerto Rico manufacture origin and that in the process of formulating or bottling the liqueurs or cocktails, the neutral cane distilled spirits of Puerto Rico is used as the primary finished ingredient, but the spirit itself is neither purified, refined or mixed with any other distilled spirit so as to change its original alcoholic characteristics. In our opinion, the process is similar to the formulating or bottling of a "piña colada" cocktail in the United States with Puerto Rican rum, where the Puerto Rican rum is used as the primary ingredient in the finished product, but the rum per se is not altered in the formulating or bottling the cocktail.

Your confirmation of our opinion would be appreciated at the earliest convenience.

Cordially,

José R. Madera.

Enclosure.

EXHIBIT A.—COFFEE LIQUEUR AT 54° PROOF

Wine gallons	Ingredients	Proof gallons
27.61	Cane neutral spirits at 190°	52.40
1.00	Coffee extract at 48°	.48
1.90	Coffee cordial flavor at 36°	.68
.40	Three fold vanilla extract at 94°	.38

EXHIBIT A.—COFFEE LIQUEUR AT 54° PROOF—Continued

Wine gallons	Ingredients	Proof gallons
50.00	High fructose corn syrup/liquid sucrose blend at 70° brix	
.15	Caramel color	
18.94	Water	
[1]100.00		54.00

[1] At 54°.

EXHIBIT B.—GREEN CREME DE MENTHE AT 54° PROOF

Wine gallons	Ingredients	Proof gallons
27.63	Cane neutral spirits at 190°	52.50
1.20	Peppermint extract at 125°	1.50
45.00	Liquid sucrose at 67° brix	
.20	Color—FD&C blue No. 1 and yellow No. 5	
25.97	Water	
[1] 100.00		54.00

[1] At 54°.

DEPARTMENT OF THE TREASURY,
BUREAU OF ALCOHOL, TOBACCO AND FIREARMS,
Washington, D.C., June 15, 1981.

Mr. JOSE R. MADERA,
Economic Development Administration,
San Juan, P.R.

DEAR MR. MADERA: This refers to your April 13, 1981, letter in which you inquired regarding the provisions of 26 U.S.C. 7652(a) as they apply to cane neutral spirits which are distilled in Puerto Rico and shipped in bulk, without payment of tax, to the United States for use in the manufacture of liqueurs, cordials and cocktails.

Section 7652(a) imposes a tax on articles of merchandise of Puerto Rican manufacture coming into the United States and withdrawn for consumption or sale. Such tax is equal to the internal revenue tax imposed in the United States upon like articles of merchandise of domestic manufacture. Section 7652(a)(3) mandates that all taxes collected on articles produced in Puerto Rico be covered into the Treasury of Puerto Rico.

In light of the passage of the Distilled Spirits Tax Revision Act of 1979, which amended the Internal Revenue Code effective January 1, 1980, distilled spirits products bottled in the United States remain in internal revenue bond until removal for consumption or sale. The amendments to the Code also included repeal of the rectification taxes imposed by Sections 5021, 5022 and 5023. Consequently, beverage distilled spirits products bottle in the United States are subject only to the distilled spirits tax imposed by Section 5001(a)(1).

Section 5232(a) states that "distilled spirits imported or brought into the United States in bulk containers may, under such regulations as the Secretary shall prescribe, be withdrawn from customs custody and transferred in such bulk containers or by pipeline to the bonded premises of a distilled spirits plant without payment of the internal revenue tax imposed on such distilled spirits." The person operating the bonded premises of the distilled spirits plant to which the spirits are transferred becomes liable for the tax on the distilled spirits so withdrawn.

Regulations implementing the provisions of Section 5232(a) are prescribed in Title 27, Code of Federal Regulations, Part 250, Subpart 1b, entitled "Shipment of Bulk Distilled Spirits from Puerto Rico, Without Payment of Tax, for Transfer from Customs Custody to Internal Revenue Bond." Regulations in 27 CFR 250.196 provide that distilled spirits may be brought into the United States from Puerto Rico in bulk containers, withdrawn by the proprietor of a distilled spirits plant from customs custody, and transferred in such bulk containers or by pipeline to the bonded premises of his plant, without payment of the internal revenue tax, if any, imposed on such spirits by 26 U.S.C. 7652. The consignee must have on file a currently valid

ATF F 5100.16 and must receive permission to ship per ATF F 5110.31 from the Secretary of the Treasury of Puerto Rico.

Regulations in 27 CFR 250.107 state that articles of Puerto Rican manufacture which are shipped to the United States and which are not exempt from tax under the provisions of 250.36 are subject under Section 7652(a) to a tax equal to the tax imposed by the internal revenue laws of the United States. Under 27 CFR 250.36c, shipments of bulk distilled spirits may be brought into the United States without payment of tax from customs custody to the bonded premises of a distilled spirits plant. Such spirits, although shipped without payment of tax, are not exempt from the tax imposed by 26 U.S.C. 7652(a).

Distilled spirits plant proprietors in the United States are taking advantage of the provisions of 26 U.S.C. 5232 by transferring without payment to tax distilled spirits produced in Puerto Rico to their plants in the United States. The proprietors have the options (1) of reducing the Puerto Rican spirits to bottling proof and bottling, labeling, and removing such products from internal revenue bond for beverage sale or consumption, or (2) of subjecting the Puerto Rican spirits to further processing into liqueurs, cordials, cocktails and other beverage products which thereby become products of manufacture of the United States, or (3) of processing such spirits in the manufacture of denatured spirits and other similar industrial use articles.

You have requested our opinion regarding whether liqueurs, cordials and cocktails formulated in the United States with cane neutral spirits produced in Puerto Rico would be considered products of Puerto Rico for purposes of covering the excise taxes paid thereon to the Treasury of Puerto Rico. The neutral spirits used in formulation of these products are indeed a product of Puerto Rico; however, subjecting such spirits to further processing in the United States in the manufacture of liqueurs, cordials, and cocktails changes the class and type of the distilled spirits and the finished product becomes a product of manufacture of the United States. However, in order to insure that the excise taxes paid thereon will be covered to the Treasury of Puerto Rico, regulations in 27 CFR 19.377 require that proprietors of distilled spirits plants maintain a separate accounting in proof gallons of Puerto Rican spirits received in the processing account for nonindustrial use, determine the percentage of overall monthly processing gains or losses of nonindustrial spirits, adjust the proof gallons of Puerto Rican spirts received in processing during the month by the percentage of overall gains or losses for the month, and file monthly reports on ATF F-5110.28 showing the adjusted proof gallons of Puerto Rican rum and other Puerto Rican spirits received in processing as provided in 27 CFR 19.786.

Liqueurs, cordials, and cocktails formulated in the United States with neutral cane spirits produced in Puerto Rico would be considered products of the United States for labeling purposes. However, 26 U.S.C. 7652(a)(3) mandates that the Federal excise taxes paid on the Puerto Rican spirits used in the formulation of these products be covered to the Treasury of Puerto Rico. You are correct in your opinion that the Federal excise taxes paid on liqueurs, cordials, and cocktails so formulated would qualify to be covered to the Treasury of Puerto Rico to the extent that the portion of the taxes paid on the base Puerto Rican spirits exclusive of other alcoholic materials used in the formulation of such products and exclusive of any losses incurred in processing and bottling would be owed to the Treasury of Puerto Rico. By requiring that bottlers report monthly the number of proof gallons of Puerto Rican spirits received plus or minus the monthly percentage of gains or losses, we believe that the regulations in 27 CFR 19.377 maintain the integrity of the procedure whereby Federal excise taxes are covered to the Treasury of Puerto Rico.

The basis of your concern appears to be various aspects of our Industry Circular No. 80-9, dated October 29, 1980. You are correct in your assumption that in certain circumstances products formulated with Puerto Rican spirits are being reported as "domestic" spirits. However, the purpose of the circular was to inform industry members of the correct way to report such products for statistical purposes only. The reporting procedure outlined in the circular will not result in the understating of the amount of Puerto Rican rum and other Puerto Rican spirits shipped into and sold in the United States.

The Bureau is concerned with insuring that the system used to collect and transfer distilled spirits taxes into the Treasury of Puerto Rico is an efficient and accurate as possible. To that end, we issued a notice of proposed rulemaking on April 13, 1981. A copy of the notice is enclosed for your information. We encourage you to direct any question or comment which you may have to ATF Specialist Michael J. Breen, of our Rulings Branch (202-566-7532).

Sincerely yours,

RICHARD A. MASCOLO,
(For Thomas George, Chief, Regulations
and Procedures Divisions).

DEPARTMENT OF THE TREASURY,
BUREAU OF ALCOHOL, TOBACCO AND FIREARMS,
Washington, D.C., January 12, 1983.

Mr. JOSE R. MADERA,
Economic Development Administration,
San Juan, P.R.

DEAR MR. MADERA: This refers to our request for our *opinion* concerning the application of 26 U.S.C. § 7652 to products from Puerto Rico. More specifically, you ask whether the following proposition is valid:

"If grain neutral spirits are imported or introduced into the island of Puerto Rico and redistilled or otherwise rectified such as, purifying, filtering, or co-mingling with cane neutral spirits, so that the final rectification of those spirits takes place in Puerto Rico, for example, as in the conversion of the neutral spirit into a Gin or Vodak, then the distilled spirit should be considered a product of Puerto Rico, as provided in 26 U.S.C. 7652."

The Bureau has consistently maintained the position that when distilled spirits are treated in Puerto Rico the finished product will be considered to be one produced in Puerto Rico under section 7652 if there has been a substantial change in the identity of the product. Something *more than token rectification is required.* This is normally a technical determination based upon laboratory analysis of the product. In the absence of an analysis of a particular product, the most we can say with certainty is that it is possible that the type of treatment you described will result in a product produced in Puerto Rico under section 7652.

Notwithstanding the above, we can say that the *conversion of neutral spirits into gin* would result in a product produced in Puerto Rico. This conclusion is based on the fact that such a conversion clearly does result in a substantial change in the identity of the product since it would effectuate a change in the class of the product under 27 C.F.R. § 5.22. It is impossible for us to speak as definitively *in the case of vodka* or other potential operations other than pursuant to a case-by-case examination of the product.

If we can be of further assistance in this matter, do not hesitate to contact us.

Sincerely yours,

THOMAS GEORGE,
Chief, Regulations and Procedures Division.

MARCH 3, 1982.

Mr. JOSE R. MADERA,
Economic Development Administration,
San Juan, P.R.

DEAR MR. MADERA: This refers to your request for our opinion as to whether a particular treatment of grain neutral spirits imported into Puerto Rico would result in a product produced in Puerto Rico within the meaning of 26 U.S.C. § 7652. You described the specific process about which you are interested as follows:

"It is proposed tc import grain alcohol into Puerto Rico which upon being redistilled locally will be purified by the removal of heads (esters and aldehydes). The resulting product may or may not be treated with charcoal or other materials, depending on specific product requirements, but in any case the final product shall be without distinctive character, aroma, taste, or colar so that it qualifies as a 'vodka'. The exact amount of heads removed will vary depending on possible variations or fluctuations in the specifications (quality) of the grain alcohol to be redistilled. The removal of heads will increase in direct proportion to the inferior composition of the grain alcohol, but the process to be carried out in Puerto Rico shall always entail purification through the redistillation of the grain alcohol with the resulting product meeting the standard of identity of a vodka. The projected process contemplates the removal of essentially 100% of the heads present in the grain alcohol."

As you know, it is the Bureau's position that when distilled spirits are treated in Puerto Rico, the finished product will be considered to be one produced in Puerto

Rico if there has been a substantial change in the identity of the product. We believe there would be such a change under the circumstances you have described. This conclusion is based on Rev. Rul. 69-496, 1969-2 C.B. 272, which held that:

"A bottler who treats neutral spirits (whether or not such neutral spirits are eligible to be described as vodka) on bottling premises or on production premises (1) with at least one once of activated carbon for each 100 wine gallons of neutral spirits or (2) by any other approved method of purifying or refining neutral spirits for the purpose of producing vodka may indicate on labels that the vodka was 'produced by' him."

Though Rev. Rul. 69-496 was concerned with labeling under the Federal Alcohol Administration Act and not with the scope of section 7652, we believe that treatment of neutral spirits sufficient for vodka to be labeled "produced by" under Rev. Rul. 69-496 results in a substantial change in the identity of the neutral spirits. Therefore, treatment of neutral spirits imported into Puerto Rico in the manner you described would result in vodka produced in Puerto Rico under section 7652.

If we can be of further assistance to you, do not hesitate to contact us.

Sincerely yours,

ROBERT E. DAUGHERTY,
Chief, Rulings Branch.

DEPARTMENT OF THE TREASURY,
BUREAU OF ALCOHOL, TOBACCO AND FIREARMS,
Washington, D.C., June 18, 1982.

Mr. JOSE R. MADERA,
Economic Development Administration,
San Juan, P.R.

DEAR MR. MADERA: This refers to our letters to you of March 3, 1982, in which we informed you of our opinion that the following treatment of grain neutral spirits imported into Puerto Rico would result in a product produced in Puerto Rico within the meaning of 26 U.S.C. § 7652.

"It is proposed to import grain alcohol into Puerto Rico which upon being redistilled locally will be purified by the removal of heads (esters and aldehydes). The resulting product may or may not be treated with charcoal or other materials, depending on specific product requirements, but in any case the final product shall be without distinctive character, aroma, taste, or color so that it qualifies as a 'vodka'. The exact amount of heads removed will vary depending on possible variations or fluctuations in the specifications (quality) of the grain alcohol to be redistilled. The removal of heads will increase in direct proportion to the inferior composition of the grain alcohol, but the process to be carried out in Puerto Rico shall always entail purification through the redistillation of the grain alcohol with the resulting product meeting the standard of identity of a vodka. The projected process comtemplates the removal of essentially 100% of the heads present in the grain alcohol."

While we continue to subscribe to our position that the above-described operation will result in a product produced in Puerto Rico within the meaning of section 7652 because the operation results in a substantial change in the identity of the neutral spirits, we wish tm clarify a statemeft which we made in our earlier letter so that it will not become a source of future confusion. In our earlier letter we gave the impression that any treatment of neutral spirits which is sufficient for vodka to be labeled "produced by" under Rev. Rul. 69-496, 1969-2 O.D. 272, would to be treatment which would result in a product produced in Puerto Rico within the meaning of section 7652.

As you know, it is the Bureau's position that treatment which effects a substantial change in the identity of the spirits results in a product produced in Puerto Rico under section 7652. Upon further consideration, we have concluded that not all treatment operations which would entitle a product to be labeled "produced by" the Puerto Rican distiller under Rev. Rul. 69-496 effect a substantial change in the identity of the neutral spirits. For example, we do not believe that the treatment of 100 wine gallons of neutral spirits with one ounce of activated carbon or a redistillation operation which merely increases the proof of the neutral spirits by one or two degrees of proof is such an operation as to cause a substantial change in the identity of the neutral spirits. As we pointed out to you in our letter of January 12, 1982, a case-by-case examination is necessary to determine whether a given treatment of neutral spirits which would entitle the finished product to be designated vodka is such as to effectuate a substantial change in the identity of the neutral spirits for purposes of the administration of section 7652.

Should you have any questions with respect to this matter, please advise.

Sincerely yours,

Robert E. Daugherty,
Chief, Ruling Branch.

Department of the Treasury,
Bureau of Alcohol, Tobacco and Firearms,
New York, N.Y., July 2, 1982.

Trigo Corp.,
G.P.O. Box 3825
San Juan, P.R.

Gentlemen: This concerns your letter of February 3, 1982, in which you inquire as to whether it would be permissible to rectify alcohol at 189 proof to purify and increase the grade to 191 or 192 proof under your rectifier's basic permit.

We further ascertained from our Puerto Rico Operations office, that you want to receive 189 proof spirits from the United States. The spirits would be increased in proof by redistillation. After redistillation, the spirits would be filtered (possibly through charcoal) to further purify them. The product to be returned to the U.S. would be designated as vodka.

Regarding redistillation, this type of operation would not be authorized under the terms of your rectifier's basic permit. A basic permit as a distiller would be necessary. Under the Federal Alcohol Administration Act, any act of distillation, whether it be original distillation or redistillation of previously produced spirits, must be done pursuant to a distiller's basic permit.

As you are probably aware, it is the Bureau's position that when distilled spirits originally produced in the United States are treated in Puerto Rico, the finished product will be considered to be one produced in Puerto Rico for .26 U.S.C. 7652 tax purposes, if there has been a substantial change in the identity of the product. However, regarding the spirits in question, we were only able to determine from our Puerto Rico Operations office that the spirits would definitely be less than 190 proof. We are still unsure of the designation of the spirits (under the Federal Alcohol Administration Act standards, they would not be entitled to certain whisky designations).

Our position on your proposal is that should the operation simply involve raising proof, spirits would not qualify as Puerto Rican manufactured, but should operation involve more than such a change (removal of esters and aldehydes, for example), then spirits would qualify. Of course, we would verify this through an appropriate analysis of spirits received and recovered.

If we can be of any further assistance, do not hesitate contacting us.

Very truly yours,

Donald C. MacVean,
Regional Regulatory Administrator.

Trigo Corp.,
San Juan, P.R., August 5, 1982.

Mr. Donald C. MacVean,
Regional Regulatory Administrator, Department of the Treasury, Bureau of Alcohol, Tobacco and Firearms, New York, N.Y.

Dear Mr. MacVean: Thank you for your letter dated July 2nd., answering ours of February 3, 1982 in which you advise that any act of distillation, whether it be original distillation or redistillation of previously produced spirits, must be done pursuant to a distiller's basic permit.

We will soon be submitting our plans for a redistilling unit to your local San Juan office and as soon as the unit is in place we will request the distiller's permit as indicated in your letter.

Our purpose is to import into Puerto Rico grain neutral spirits over 190° proof and redistill and filter them through activated charcoal, removing substantially all esters and aldehydes to produce vodka for bottling in the U.S.A.

Since the above operation is not simply raising proof but rather a substantial redistilling and filtering process, modifying and changing the spirits through changes similarly expressed in your letter, we believe that the vodka thus produced will be considered to be one produced in Puerto Rico for 26 U.S.C. 7652 tax purposes and would appreciate your confirmation of this.

Very truly yours,

Benigno Trigo II, *President.*

Department of the Treasury,
Bureau of Alcohol, Tobacco and Firearms,
Washington, D.C., September 10, 1982.

Mr. Benigno Trigo, II,
Trigo Corp.,
San Juan, P.R.

Dear Mr. Trigo: Mr. MacVean has asked me to respond to your letter of August 5, 1982, to him in which you request confirmation that vodka, produced by the redistillation and activated charcoal filtration of neutral spirits grain imported from the United States, will be considered as a product of Puerto Rican manufacture for 26 U.S.C. 7652 tax purposes.

Unfortunately, we cannot give you a definitive answer to the question without analyzing the product before and after the redistillation/filtration operations.

Your letter indicates that the process will remove "substantially all esters and aldehydes" present in the neutral grain spirits during the course of their conversion to vodka. This description of the planned operation connotates the same isues that was asked of us by the Puerto Rican Economic Development Administration. The EDA indicated that the projected process "contemplates the removal of essentially 100% of the heads present in the grain alcohol."

As you may be aware, we advised the EDA that, based on its description of the projected operations, the resulting spirits would have undergone a substantial change in identity and thus would be considered a product of Puerto Rican manufacture for 26 U.S.C. 7652 tax purposes. However, we must emphasize that this position is based solely on the projected results. If the actual operations do not result in the same degree of change to the spirits which has been described for the projected operations, our position may be different.

Again, before we can give you a definitive answer, it will be necessary to analyze the product subjected to the operations. We suggest that, upon receipt of spirits to be so redistilled and/or filtered, you contact our Chief, Puerto Rican Operations in Hato Rey to arrange for procurement of representative samples.

Sincerely yours,

Robert E. Daugherty,
Chief, Rulings Branch.

Department of the Treasury,
Bureau of Alcohol, Tobacco and Firearms,
Washington, D.C., April 11, 1983.

Mr. Victor Gallicchio,
Heublein Spirits Group,
Hartford, Conn.

Gentlemen: This is a reply to your request for a description of the procedures which should be followed in connection with the redistillation of light whisky designate in Puerto Rico so that those spirits will qualify as products of Puerto Rico for tax purposes under the provisions of USC 7652 when returned to the United States.

The following conditions would have to be met:

(1) The product would have to be light whisky designate and meet the requirements of 27 CFR 5.22(b) and 5.22(b)(3), with the exception that it need not be stored in oak cooperage. In addition, to avoid any further controversy, the proof of the light whisky designate should be between 160° and 170°.

(2) Records on file at the premises of the producer of the light whisky designate and/or records on file at the premises of the producer of the neutral spirits must show that the neutral spirits returned from Puerto Rico were, in fact, produced from the light whisky designate that was originally transported to Puerto Rico. ATF should be able to trace the product from the mash bill through the production records to the export document (ATF Form 5100.11, Withdrawal of Spirits, Specially Denatured Spirits or Wine for Exportation). The documents returning the spirits to the United States (ATF Form 5110.31, Application and Permit to Ship Puerto Rican Spirits to the United States Without Payment of Tax) should show the formula number under which the neutral spirits were produced.

(3) Samples from each shipment going to Puerto Rico and samples from the returning shipments must be set aside on Heublein plant premises and identified using ATF Forms 5100.11 and 5110.31 serial numbers respectively. The samples must be analyzed and the results of such analysis kept on file on Heublein premises.

(4) The distillery in Puerto Rico must submit a formula showing the class, type and proof range of spirits received for redistillation under the provisions of 27 CFR 5.25 and the class and type of spirits resulting from the process.

(5) The distillery in Puerto Rico must not mingle the light whisky designate with other than spirits of the same class and type produced by the same mainland producer. Shipments returning to the United States must consist only of the NSG produced from the light whisky designate from Heublein using the formula submitted by Destileria Serralles.

(6) The samples taken from the outgoing and the returning products will be used to determine if those spirits meet the conditions of the formula submitted by the distillery in Puerto Rico and approved by the Bureau. Any deviation from the formula i.e. lack of whisky characteristics, failure of returned spirits to meet NSG standards, etc. would be reason to disallow the taxes to be covered to Puerto Rico.

(7) Records must be maintained which will allow the Bureau to trace the amounts of spirits, in proof gallons, exported to Puerto Rico and the amounts, in proof gallons, returned from Puerto Rico under this program.

Compliance with these procedures should avoid future problems related to the tax status of the distilled spirits being returned from Puerto Rico. If we can be of further assistance, please call or write.

Sincerely yours,

THOMAS GEORGE,
Chief, Regulations and Procedures Division.

DEPARTMENT OF THE TREASURY,
BUREAU OF ALCOHOL, TOBACCO AND FIREARMS,
Washington, D.C., May 24, 1983.

Mr. ALBERT J. TORRUELLA,
Destileria Serralles, Inc.,
Mercidita, P.R.

DEAR MR. TORRUELLA: Enclosed is an advance copy of the ATF ruling relating to the redistillation of distilled spirits in Puerto Rico. In essence, the ruling holds that NSG and distilled spirits ranging in proof from 160 to 190 degrees and are essentially neutral in character do not become products of Puerto Rico by mere redistilling and are, thus, not eligible for the excise tax to be returned to the Treasury of Puerto Rico under the provisions of 26 USC 7652

I believe that this will preclude any further confusion and/or controversy with regard to questions on the tax eligibility of these spirits under the provisions of 26 USC 7652.

If you have any other questions, please feel free to write or call.

Sincerely yours,

ALAN B. GRAHAM
(For Thomas George, Chief,
Regulations and Procedures Division).

Enclosure.

PART II-A

27 CFR PART 250.35: TAXABLE STATUS (ALSO 27 CFR PART 250.200)

ATF Rul. 83-

Distilled spirits produced in the United States and transferred to Puerto Rico for processing are articles produced in Puerto Rico within the meaning of 26 U.S.C. § 7652 if such distilled spirits have undergone a substantial change in identity.

The Bureau of Alcohol, Tobacco and Firearms (ATF) has been asked whether distilled spirits originally produced in the United States and transferred to Puerto Rico for further treatment are articles produced in Puerto Rico within the meaning of 26 U.S.C. § 7652 under the circumstances described below.

Situation #1. Distilled spirits are produced in the United States at 190 degrees of proof and are transferred from the United States to Puerto Rico. The spirits are then subjected to a distillation process pursuant to which esters, aldehydes, and other contaminants are totally removed. The proof of the spirits may or may not be increased. The distilled spirits are then returned to the United States as neutral spirits grain or are charcoal filtered and then returned to the United States as vodka.

Situation #2. Distilled spirits are produced in the United States at more than 160 degrees of proof but less than 190 degrees of proof. Such spirits lack the characteristics attributed to whisky, brandy, rum, or gin and are substantially neutral in character. The spirits are transferred from the United States to Puerto Rico and are then subjected to a redistillation process which increases the proof of the spirits to 190 degrees or above. The distilled spirits are then returned to the United States as neutral spirits.

Section 7652(a)(1), Title 26, United States Code, provides:

(1) Rate of tax. Except as provided in section 5314, articles of merchandise of Puerto Rican manufacture coming into the United States and withdrawn for consumption or sale shall be subject to a tax equal to the internal revenue tax imposed in the United States upon the like articles of merchandise of domestic manufacture.

Section 7652(a)(3) provides:

(3) Deposit of internal revenue collections. All taxes collected under the internal revenue laws of the United States on articles produced in Puerto Rico and transported to the United States (less the estimated amount necessary for payment of refunds and drawbacks), or consumed in the island, shall be covered into the treasury of Puerto Rico.

The terms "articles of merchandise of Puerto Rican manufacture" as used in section 7652(a)(1) and "articles produced in Puerto Rico" as used in section 7652(a)(3) have the same meaning. *Commonwealth of Puerto Rico v. Blumenthal,* 642 F.2d 622 (D.C. Cir. 1980), *cert. denied,* 451 U.S. 983 (1981). As to the extent of treatment necessary to constitute "manufacture," the Supreme Court has said:

Manufacture implies a change, but every change is not manufacture, and yet every change in an article is the result of treatment, labor and manipulation. But something more is necessary, as set forth in *Hartranft v. Wiegmann,* 121 U.S. 609. There must be transformation; a new and different article must emerge, "having a distinctive name, character or use." *Anheuser-Busch Brewing Association v. United States,* 207 U.S. 556, 562 (1908).

For tax purposes in order for distilled spirits originally produced in the United States to become "articles produced in Puerto Rico" after treatment in Puerto Rico, such spirits must undergo a substantial change in identity. Token treatment is not sufficient. The spirits must undergo substantial changes in taste, aroma and chemical composition. In short, a new and different article must emerge.

However, for labeling purposes, 27 C.F.R. § 5.36(a)(3) provides that a bottler who treats neutral spirits with activated carbon may, in lieu of the phrase bottled by, indicate on labels that the vodka was "produced by" such bottler.

In situation #1, the distilled spirits did undergo a change as esters, aldehydes and other contaminants were removed. However, the spirits were "neutral spirits" when they were shipped to Puerto Rico and "neutral spirits" when they were returned to the United States. *See,* 27 C.F.R. § 5.22(a). The changes in taste, aroma and chemical composition were not substantial. A new and different article did not emerge as the distilled spirits produced in the United States did not undergo a substantial change in identity as a result of their treatment in Puerto Rico. *Held,* the distilled spirits transported to the United States are not articles produced in Puerto Rico within the meaning of section 7652(a)(3).

In situation #2, the distilled spirits originally produced in the United States were subjected to a redistillation operation in Puerto Rico that increased the proof of the spirits. Though the spirits were changed to the extent that there was a rise in proof, after redistillation the spirits still lacked the taste, aroma and other characteristics of whisky, brandy, rum, or gin, and were neutral spirits within the meaning of 27 C.F.R. § 5.22(a). Therefore, the changes in taste, aroma, and chemical composition were not substantial. A new and different article did not emerge as the distilled spirits produced in the United States did not undergo a substantial change in identity as a result of their treatment in Puerto Rico. *Held,* the distilled spirits transported to the United States are not articles produced in Puerto Rico within the meaning of section 7652(a)(3).

The provisions of section 7652(b), pertaining to the taxation of articles coming into the United States from the Virgin Islands, are in all essential aspects identical to the provisions of section 7652(a). Accordingly, this ruling applies to the classification of products entering the United States from the Virgin Islands.

Under the authority contained in 26 U.S.C. 7805(b), this ruling will be applied to distilled spirits redistilled in Puerto Rico as described herein after May 9, 1983.

Department of the Treasury,
Bureau of Alcohol, Tobacco and Firearms,
Washington, D.C., June 2, 1983.

Mr. Victor Gallicchio,
Heublein Spirits Group,
Hartford, Conn.

Dear Mr. Gallicchio: This is in reply to your letter of June 1, 1983 in which you outlined your proposed method for complying with recordkeeping and sampling requirements in the Puerto Rican redistillation program.

You proposed the following:

1. Tanks, designated for light whisky designate use only, will be filled before any removals are made. Each filled tank will be assigned a lot number. The lot number will be used on all ATF documents and samples and shipping documents connected with removals from that tank and lot.

2. Distilleria Serralles will assign tanks and lot numbers in a similar manner for the redistilled product. Those lot numbers will also be associated with all ATF documents and samples and shipping documents.

3. Samples from both the spirits shipped to Puerto Rico and the redistilled spirits returned to the United States, will be maintained at Hartford.

We do not find any problems with your proposal and it is approved with the following addition: Copies of all documents showing the transfer of spirits to and from Puerto Rico (ATF Form 5100.11 and 5110.31) will also be maintained in the files at Hartford.

If we can be any further help, please feel free to write or call.

Sincerely yours,

Alan B. Graham
(For Thomas George, Chief,
Regulations and Procedures Division).

Department of the Treasury,
Bureau of Alcohol, Tobacco and Firearms,
Washington, D.C., June 3, 1983.

Mr. Victor Gallicchio,
Heublein Spirits Group,
Hartford, Conn.

Dear Mr. Gallicchio: This letter is being sent to inform you of the results of the National Laboratory's analysis of two samples of distilled spirits processed in your Puerto Rican Redistillation Program.

You provided two samples. The first sample was from a light whisky designate shipment at 169.6 degrees proof which was transferred to Destilleria Serralles for processing. The second sample was from a neutral grain spirits shipment at 192.9 degrees proof transferred to the United States after redistillation in Puerto Rico.

The test results show that there was a substantial change in the product returned to the United States when compared to the product shipped to Puerto Rico. The product so redistilled would qualify as a product of Puerto Rico for tax purposes as outlined in the Bureau's April 11, 1983 letter to you.

If we can be of further help, please feel free to write or call.

Sincerely yours,

Alan B. Graham
(For Thomas George, Chief,
Regulations and Procedures Division).

Department of the Treasury,
Bureau of Alcohol, Tobacco and Firearms,
Washington, D.C. June 2, 1983.

Mr. Victor Gallicchio,
Heublein Spirits Group,
Hartford, Conn.

Dear Mr. Gallicchio: This is in reply to your letter of June 1, 1983 in which you outlined your proposed method for complying with recordkeeping and sampling requirements in the Puerto Rican redistillation program.

You proposed the following:

1. Tanks, designated for light whisky designate use only, will be filled before any removals are made. Each filled tank will be assigned a lot number. The lot number will be used on all ATF documents and samples and shipping documents connected with removals from that tank and lot.

2. Distilleria Serralles will assign tanks and lot numbers in a similar manner for the redistilled product. Those lot numbers all also be associated with all ATF documents and samples and shipping documents.

3. Samples from both the spirits shipped to Puerto Rico and the redistilled spirits returned to the United States, will be maintained at Hartford.

We do not find any problems with your proposal and it is approved with the following addition: Copies of all documents showing the transfer of spirits to and from Puerto Rico (ATF Form 5100.11 and 5110.31) will also be maintained in the files at Hartford.

If we can be of any further help, please feel free to write or call.

Sincerely yours,

ALAN B. GRAHAM
(For Thomas George, Chief,
Regulations and Procedures Division.)

DEPARTMENT OF THE TREASURY,
BUREAU OF ALCOHOL, TOBACCO AND FIREARMS,
Washington, D.C.

Mr. DEREK T. WEATHERILL,
The Distillers Company, Ltd.
Stamford, Conn.

DEAR MR. WEATHERILL: This is in reply to your letter dated August 29, 1983, in which you request information regarding the conditions for the redistillation of light whiskey designate in Puerto Rico to make neutral grain spirits. In order for the light whiskey designate spirits to qualify as products of Puerto Rico for tax purposes under the provisions of 26 U.S.C. 7652 when returned to the United States, the following conditions should be met:

(1) The product would have to be light whiskey designate and meet the requirements of 27 CFR 5.22(b) and 5.22(b)(3), with the exception that it need not be stored in oak cooperage. In addition, to avoid further controversy, the proof of the light whiskey designate should be between 160° and 170°.

(2) Records of file at the premises of the producer of the light whiskey designate, and/or records on file at the premises of the producer of the neutral spirits must show that the neutral spirits returned from Puerto Rico were, in fact, produced from the light whiskey designate that was originally transported to Puerto Rico. ATF should be able to trace the product from the mash bill through the production records to the export document. (ATF Form 5100.11, Withdrawal of Spirits, specially Denatured Spirits or Wine for Exportation). The documents returning the spirits to the United States (ATF form 5110.31, "Application and Permit to Ship Puerto Rican Spirits to the United States Without Payment of Tax") should show the formula number under which the neutral spirits were produced.

(3) In order to facilitate recordkeeping procedures, tanks at the U.S. source, designated for light whiskey designate only, should be filled before any removals are made. Each filled tank would then be assigned a lot number, which can then be used on all ATF documents, samples, and shipping documents connected with removals from that tank and lot.

(4) Samples from each shipment going to Puerto Rico and samples from the returning shipments must be set aside on the plant premises, and identified using ATF forms 5100.11 and 5110.31 serial numbers respectively. The samples must be analyzed and the results of such analysis kept on file on the plant premises.

(5) The distillery in Puerto Rico must submit a formula showing the class, type, and proof range of spirits received for redistillation under the provisions of 27 CFR 5.25, and the class and type of spirits resulting from the process.

(6) The distillery in Puerto Rico must not mingle the light whiskey designate with other than spirits of the same class and type produced by the same mainland producer. Shipments returning to the U.S. must consist only of the neutral grain spirits produced from the light whiskey designate from your plant.

(7) The samples taken from the outgoing and returning products will be used to detemine if those spirits meet the conditions of the formula submitted by the distillery in Puerto Rico and approved by the Bureau. Any deviation from the formula, i.e. lack of whiskey characteristics, failure of returned spirits to meet NSG stand-

ards, etc., would be reason to disallow the taxes for that shipment to be covered to the Puerto Rican Treasury.

(8) Records must be maintained which will allow the Bureau to trace the amounts of spirits, in proof gallons, exported to Puerto Rico, and the amounts, in proof gallons, returned from Puerto Rico under this program.

(9) After the NSG is returned to the U.S. from Puerto Rico it may not be treated in any manner that will constitute a substantial change in its characteristics in order for it to qualify as a product of Puerto Rico for tax purposes under 26 U.S.C. 7652.

Compliance with these procedures should avoid any problems related to the tax status of the distilled spirits being returned from Puerto Rico. If we can be of further assistance, please call or write.

Sincerely yours,

THOMAS GEORGE,
Chief, Regulations and Procedures Division.

DEPARTMENT OF THE TREASURY,
BUREAU OF ALCOHOL, TOBACCO AND FIREARMS,
Washington, D.C., October 3, 1983.

Mr. DEREK T. WEATHERILL,
The Distillers Company, Ltd.,
Stamford, Conn.

DEAR MR. WEATHERILL: This is in reply to your letter dated September 19, 1983, in which you requested information on the conditions to be met in order for redistilled corn whiskey to qualify as a product of Puerto Rico for tax purposes under the provisions of 26 U.S.C. 7652.

In order for the redistilled corn whiskey to qualify, it must meet the same conditions as stated previously in our letter dated September 15, 1983, for light whiskey designate. Distilled spirits produced in the United States and redistilled in Puerto Rico must undergo a substantial change in identity to qualify as articles produced in Puerto Rico for tax purposes. The spirits must have undergone substantial changes in aroma, taste, and chemical composition. Further, when the NSG is returned to the U.S., it may not be treated in any manner that will constitute a substantial change in its characteristics in order for it to be considered a product of Puerto Rico for tax purposes under 20 U.S.C. 7652.

If we can be of further assistance, please call or write.

Sincerely yours,

THOMAS GEORGE,
Chief, Regulations and Procedures Division.

Mr. SCHWAM. Mr. Chairman, my name is Stanley Schwam and Mr. Lux asked if I would read part of his statement, if I may.

Mr. GIBBONS. All right, but be brief. I have a 4:15 appointment with the Governor. I have to go see him.

Mr. SCHWAM. Well, under the circumstances we will just leave it. Please enter his statement into the record.

Mr. GIBBONS. Does he support the general thrust of what has been said here?

Mr. SCHWAM. Yes, he definitely supports it and he is in favor of it being discontinued.

I would like to say about two words or three words as the chairman of the board of the American Beverage Alcohol Association, which is an industry organization of producers—that is, bottlers and distillers and brokers and importers.

We made a survey of our membership and we have members in many states of the union, including Massachusetts, New Jersey, California, Pennsylvania, Illinois, Missouri, Florida and Ohio. Of those returning their reply to the survey, 93 percent, they are in favor of H.R. 4702.

Thank you, sir. I am ready for any questions.

Mr. GIBBONS. Thank you, sir.

Mr. Serralles.

STATEMENT OF FELIX JUAN SERRALLES, PRESIDENT AND CHIEF EXECUTIVE OFFICER, SERRALLES DISTILLERY, INC.

Mr. **Serralles**. Mr. Chairman, my name is Felix Serralles. I am president and chief executive officer of the Serralles Distillery, Puerto Rico's only local wholly owned distillery.

I appreciate this opportunity to testify today before you to express our deep concerns regarding H.R. 4702. This bill, which would dramatically change a longstanding principle established in 1900 relating to the fiscal autonomy of the Commonwealth of Puerto Rico, is being rushed through Congress in a matter of days, without giving Members the opportunity of considering adequately the views of industry in general and all responsible public sectors, both in Puerto Rico and in the U.S. mainland.

Our small local industry has been charged with an attempt to engineer an abusive scam to disrupt a segment of the national spirits market and raid the U.S. Treasury. I should like to address these two accusations and set forth the true facts relating to this issue.

Beginning in 1976, both the Government and the spirits industry of Puerto Rico requested in good faith a series of rulings from the U.S. Treasury, seeking guidance and confirmation as to which processes would result in distilled spirits deemed produced in Puerto Rico. Treasury issued a number of rulings between 1976 and 1983, copies of which are enclosed with my testimony for your record.

One of these rulings involved redistillation of unaged light whiskey. That ruling clearly concluded that the ensuing article would be deemed a product of Puerto Rico. Since Puerto Rico does not produce grain, in order to produce grain spirits we only have three alternatives: bring in the grain, or bring in beer—called fermented mash—or bring in beer without most of the water, a product of primary distillation called whiskey.

We followed the third alternative because it offers the lowest transportation cost from the United States. The U.S. Treasury is amply satisfied that the redistillation process results in a substantial change and qualifies the end product under section 7652 as a product of Puerto Rico.

I wish to underline that we have relied on these official representations of the U.S. Government. On this basis, we made substantial investments in our plant to undertake these operations.

With respect to the allegations of market disruption, I should like to state that no evidence has been advanced to support it. Indeed, an analysis of pricing in the marketplace does not reveal any market disruption. Furthermore, our payments to the mainland bottler to cover interest and other overhead expenses, which constitute the only payments received by said bottler for other than direct costs, only amount to 35 cents per proof gallon. Even if this were to be considered as a profit margin, which it is not since a lot of expenses have to be covered by these 35 cents, the impact of this payment would amount to only 5.5 cents per bottle of 750 milliliters, a bottle which retails for $5 to $6 dollars in the marketplace.

Clearly, the amounts involved cannot produce any distortion in the marketplace. We recognize, however, that there is a concern by Federal revenue officials that Federal excise rebates may balloon uncontrollably in future years. The Commonwealth of Puerto Rico has proposed a dollar limit on the Federal excise taxes to be covered over to the Puerto Rico treasury under the redistillation program. We believe that this is a fair proposal which should resolve the U.S. Government's fiscal concerns.

In conclusion, it is my considered opinion that H.R. 4702 constitutes a radical departure in Federal fiscal policy for Puerto Rico which, if done in a hasty manner, could have the gravest economic consequences for Puerto Rico.

We respectfully urge this committee to postpone consideration of this matter until opportunity is provided to both mainland and island public and private sector constituencies to prudently analyze and inform the Congress of the effects of this legislation. We further recommend to the committee that in analyzing this matter, they consider the following:

With respect to market disruption, No. 1, develop a mechanism with objective criteria to determine whether market disruption has taken place; and, two, if such a determination is made, that appropriate sanctions and remedies be established.

With respect to Federal revenue losses: One, that a cap on the amount of Federal excise taxes rebated to Puerto Rico pursuant to the alcohol redistillation program be established to provide budgeting predictability to the U.S. Government;

Two, in the event that Federal excise taxes on rum covered over to Puerto Rico decline, that the shortfall be made up through temporary increases in the redistillation program;

Three, the redistillation program should be effective for the life of the CBI program;

Four, with respect to the value-added test, the standard should remain the substantial change test which has been in effect since 1900;

And five, with respect to the Federal tax subsidy provisions, we submit that they are vague and should be deleted.

In addition, Mr. Chairman, I would like to comment on this morning's reference that Treasury did not know of Puerto Rico's incentive program. Appendices No. 3 and No. 5 of Mr. Bordeaux' testimony showed internal Treasury correspondence dated in March and June 1982, evidencing full knowledge of the Puerto Rico incentive program.

I personally met with Treasury officials in March 1983 and I know they were familiar with the incentive program. My meeting was with the Acting Director for Regulatory Enforcement, the Chief of Regulations and Procedures Division, and the General Counsel of the Bureau of Alcohol of the Treasury Department. I also know personally that the BATF office in Puerto Rico has constantly monitored the program and is fully aware of the incentives given by the Puerto Rican Industrial Development Co.

I thank the committee and would welcome an opportunity to work with Congressman Stark and the committee staff on this very important issue. Thank you.

[The prepared statement follows:]

STATEMENT OF FELIX J. SERRALLES, PRESIDENT AND CHIEF EXECUTIVE OFFICER, DESTILERIA SERRALLES, INC.

My name is Felix J. Serralles. I am President and Chief Executive Officer of Destileria Serralles, Inc., Puerto Rico's only wholly locally-owned distillery. I appreciate this opportunity to testify today before you to express our deep concerns regarding H.R. 4702.

The Serralles family has been producing distilled spirits in Puerto Rico since 1845. Our best known product is Don Q rum.

At the outset, I should like to state that we find it highly objectionable that this Committee should consider this legislation in the context of its consideration of tax scams and evasions and other unrelated tax abuses. Moreover, this bill, which would dramatically change a long standing principle established in 1900 relating to the fiscal autonomy of the Commonwealth of Puerto Rico, is being rushed through Congress in a matter of days without giving the members the opportunity of considering adequately the views of industry in general and all responsible public sectors both in Puerto Rico and in the United States mainland. We are being presumed guilty of provoking an alleged market disruption based on hearsay without any concrete evidence and without a reasonable opportunity for rebuttal.

Mr. Chairman, I truly believe the situation described above is happening only because we are located in Puerto Rico, and would certainly not occur if we were located in any state of the union.

Our small local industry has been charged with an attempt to engineer an abusive scam to disrupt a segment of the national spirits market and raid the U.S. Treasury.

I should like to address these two accusations and set forth the true facts relating to this issue.

Let us look briefly at the history of section 7652 of the Internal Revenue Code, which H.R. 4702 seeks to modify.

Section 7652 provides for the rebating to the Commonwealth of Puerto Rico of all federal excise taxes collected on articles produced in Puerto Rico. This principle, so fundamental to United States-Puerto Rico fiscal relations, was first established by Congress in 1900 and has been ratified thereafter by Congress in 1917 and again in 1950.

The purpose of this provision is simple and straightforward. Any article which originates or undergoes a substantial change in Puerto Rico is deemed a product of Puerto Rico for the purposes of this law. This is a well established concept under federal law and trade practices which acknowledges the need of any modern community like Puerto Rico to import raw materials not found on the island in the production of articles for commerce. Without this concept no community could call the following articles their own: a sweater produced from imported wool; jewelry made out of imported gold and precious stones; cigarettes or cigars using imported tobacco and/or paper; or petroleum derivatives or plastics produced by secondary refining processes from imported feedstocks.

Beginning in 1976, both the Government and the spirits industry of Puerto Rico requested in good faith a series of rulings from the U.S. Tresury seeking guidance and confirmation as to which processes would result in distilled spirits deemed produced in Puerto Rico. Treasury issued a number of rulings between 1976 and 1983, copies of which I enclose with my testimony for your record.

One of these rulings involved redistillation of unaged light whiskey. That ruling clearly concluded that the ensuing article would be deemed a product of Puerto Rico.

Let me explain briefly the process of redistillation because an impression has been created to the effect that it is a mere cosmetic process.

Redistillation requires a raw material (unaged light whiskey) which contains a proof of between 160° and 170° (80 to 85% alcohol) and which has the characteristics of a whiskey, referring to its laboratory analysis and organoleptic qualities.

This raw material is subjected to an extensive distillation with four different distillation columns. In contrast, our production of rum requires five columns.

The resulting products is a grain neutral spirit of vodka quality (in our case having 192° proof, equivalent to 96% alcohol) which is without odor, color, or taste, and which must pass a laboratory analysis demonstrating that substantially all impurities have been removed.

In order to document that a substantial change has taken place, the BATF requires the taking and maintaining of samples of the raw material and of the resulting product, together with its corresponding laboratory analysis.

A full distillation process would require the use of all five of our distilling columns. Under our redistillation program we use four. Since Puerto Rico does not produce grain, in order to produce grain spirits we would only have three alternatives: bring in grain or "beer" (fermented mash) or beer without most of the water. We follow the third alternative because it offers the lowest transportation cost. The U.S. Treasury is amply satisfied that the redistillation process results in a substantial change and qualifies the end product under section 7652 as a product of Puerto Rico.

I wish to underline that we at all times went before the proper federal authorities to seek authorization for these operations, openly and with clean hands, and that we have relied on these official authorizations and representations by the U.S. Government. On the basis of our good faith reliance on these Treasury rulings, we made substantial investments in our plant to undertake these operations.

I believe it is highly unfair for anyone to accuse us of abusing the letter or the intent of Congress. Indeed, if any abuse has been committed, is has been committed against us by those who would deprive us retroactively of the benefits of those investments we made relying upon the representations made by the Federal Government.

With respect to the allegation of market disruption, I should like to state that no evidence has been advanced to support it. Indeed, an analysis of pricing in the marketplace does not reveal any market disruption. Furthermore, our payments to the mainland bottler to cover interest and other overhead expenses (which constitute the only payments received by said bottler for other than direct costs), only amount to 35 cents per proof gallon. Even if this were to be considered as a profit margin, which it is not, the impact of this payment would amount to only approximately 5-½ cents per bottle of 750 ml., a bottle which retails for $5 to $6 in the market. Clearly, the amounts involved cannot produce any distortion in the marketplace.

We recognize, however, that there is a concern by federal revenue officials that federal excise rebates may balloon uncontrollably in future years. The Commonwealth of Puerto Rico has proposed a dollars limit on the federal excise taxes to be covered over to the P.R. Treasury under the redistillation program. We believe that this is a fair proposal which should resolve the U.S. Government's fiscal concerns.

Turning to H.R. 4702, I would point to the following specific problems in that legislation.

As you know, H.R. 4702 proposes to resolve this issue through the establishment of three separate requirements in order for a product to qualify as a product of Puerto Rico:

That the original distillation of distilled spirits occur in Puerto Rico;

That 50 percent of the value of the spirits be added in Puerto Rico; and

That such article not receive a federal excise tax subsidy as defined in the bill.

As to the first requirement, we believe it is burdensome and unreasonable for the following reasons:

(a) It would preclude Puerto Rico from participating in many aspects of the cordials business where it is an established and accepted procedure to produce a cordial from the mixing of more than one type distilled spirit. For instance, a brandy mixed with a rum or coffee flavored cane neutral spirit would fall under this prohibition since the brandy (or a whiskey based spirit) would not be the object of an original distillation in Puerto Rico.

(b) The provisions of the Caribbean Basin Economic Recovery Act of 1982 (CBI) do not preclude a CBI country from importing into the U.S. market redistilled spirits free of customs duties which are heavily subsidized by said countries.

(c) This is not a reasonable test to measure whether a product should be considered one manufactured in Puerto Rico as it ignores the extent or value added by the Puerto Rico operations.

As to the second requirement, we believe that it is more prejudicial to Puerto Rico than the value added requirements imposed upon CBI countries. In the CBI, the cost of materials and value added must be 35 percent of the value upon introduction, but they also permit up to 15 percent of said amount to be covered by the value of materials acquired from the United States (excluding Puerto Rico, incidentally, which is yet another instance of discrimination). This means that in the case at hand where whiskey is purchased in the United States for further distillation in Puerto Rico into vodka the value added requirement should be 20 percent in order to place Puerto Rico on a par with CBI countries.

Further, the 50 percent value added requirement is particularly unreasonable in the case of alcoholic beverages and distilled spirits because of their intrinsic high margins in the marketplace. Specifically, it would be practically impossible for any

Puerto Rican spirits to qualify under this provision, even rum, were it not otherwise specifically excluded.

It should be clear that no matter what the cost of the Puerto Rican operation, high sales value items (such as some cordials and premium grade brands in general) would never qualify under the test because of their high sales prices in relation to total direct manufacturing costs. The value added requirement should be kept at a low level to avoid inequities. It should certainly not exceed 20 percent and should contain a provision for periodic review of high margin items. We estimate that in some cases, such as very expensive cordials and super premiums, the direct manufacturing costs may typically be as low as 10 percent of the sales value to the producer.

As to the third requirement of H.R. 4702, its language is extremely vague and imprecise and, we believe, could easiy lead to litigation. It would be extremely difficult to administer as well. It would also represent a serious limitation to Puerto Rico's power and ability to govern itself.

For over 30 years the Government of Puerto Rico has been granting incentives in different forms, through advertising, tax exemptions and now through direct allocation of funds for the purpose of attracting industry to the island. This is, of course, an effective and valid use of Puerto Rico's legal prerogatives within its relationship with the United States.

In conclusion, it is my considered opinion that H.R. 4702 constitutes a radical departure in federal fiscal policy for Puerto Rico, which if done in a hasty and unthinking manner, could have the gravest economic consequences for Puerto Rico. This is not as simple an issue as some people would have Congress believe. The economic framework of Puerto Rico is a delicately balanced instrument which has been constructed through many years of careful study and consideration. H.R. 4702 constitutes a simplistic solution whose consequences need to be carefully evaluated. We respectfully urge this Committee to postpone consideration of this matter until an opportunity is provided to both mainland and island public and private sector constituencies to prudently analyze the effects of this legislation.

We further recommend that the Committee, in analyzing this matter, consider the following:

With respect to market disruption:

1. Develop a mechanism with objective criteria to determine whether market disruption has taken place; and
2. If such a determination is made, that appropriate sanctions and remedies be established.

With respect to federal revenue losses:

1. That a cap on the amount of federal excise taxes related to Puerto Rico pursuant to the alcohol redistillation program be established to provide budgeting predictability to the U.S. Government. Such a cap should provide for a reasonable escalation clause;
2. In the event that federal excise taxes on rum covered over to Puerto Rico decline for any reasons, that the shortfall be made up through temporary increases in the redistillation;
3. The redistillation program should be effective for the life of the CBI program;
4. With respect to the value-added test, the standard should remain the substantial change test which has been in effect since 1900; and
5. With respect to the federal tax subsidy provisions, we submit that they are vague and should be deleted.

Mr. **Stark** [presiding]. Thank you very much, Mr. Serralles.

I just have one question. Mr. Bordeaux, if there is no competitive impact, why would you oppose what is going on in Puerto Rico, or are you just mad at the guys in Puerto Rico?

Mr. **Bordeaux**. Well, there is an obvious anticompetitive impact. It is easy to say it is only 7.5 cents a bottle when you think about it in individual bottles. But you are talking of hundreds of millions of dollars in bottles, and this comes back to be millions of dollars, which can be used for all types of advantages in the marketplace.

We are also talking about a commodity which we had tried to get involved in the program as well as other of our competitors. It has been limited to only a few players in the marketplace.

Mr. STARK. One, could you either now or later for the record, could you quantify what you perceive or what you know to be the case in imports?

And second, I asked that question this morning and I got an answer that I did not quite understand, but perhaps you could state it more clearly for me. I did suggest that part of this problem arose because somebody in Puerto Rico would not let anybody else into the deal, and I was told that then the Government did not have anything to do with that, there was some other corporation and they did not have enough money to let other people in.

Did you try and do the same thing that the other two distilleries are doing?

Mr. BORDEAUX. Yes.

Mr. STARK. Why did they not let you in?

Mr. BORDEAUX. We never got any calls back, but Mr. Lux, who is not here today, has documentation of letters that he submitted and his counsel in Puerto Rico wrote back to him saying that it was closed to further participants.

Mr. STARK. Just closed?

Mr. BORDEAUX. Closed.

Mr. STARK. Would you submit, if you can, some of the figures in terms of what this means in a competitive sense.

Mr. BORDEAUX. Well, in my statement I have indicated the advantage available.

Mr. STARK. Thank you. Thank you very much, and I will look at your complete statement, which will be part of the record.

Mrs. Kennelly.

Mrs. KENNELLY. Thank you, Mr. Chairman.

I would like to direct my questions to Mr. McGarry. It is my understanding from your testimony, Mr. McGarry, that you went into the redistillation program after receiving the go-ahead from the Bureau of Alcohol, Tobacco and Firearms, and you made certain business transactions and investments relying on this approval.

As a result of relying on BATF, if the program was to be eliminated in say 6 months, what do you think would happen?

Mr. McGARRY. Well, as outlined in my testimony, I think the immediate impact would be, certainly it would put our loan in jeopardy. The brand Don Q rum, supply thereof, would be in jeopardy. Those principally, I mean, because if you remember what I said was we entered into the program primarily to sustain a position in the marketplace as a full line supplier. The loss of the brand would jeopardize that.

Mrs. KENNELLY. So you would lose on your investment, you would lose on the money that you loaned, you would lose one of your lines so you would not be full line supplier?

Mr. McGARRY. That is correct.

Mrs. KENNELLY. And this is because you went along with something that you asked the Bureau of Alcohol, Tobacco and Firearms if you could do?

Mr. McGARRY. That is right.

Mrs. KENNELLY. You mentioned an 1986 date, Mr. McGarry?

Mr. McGARRY. I am sorry?

Mrs. KENNELLY. You mentioned a 1986 date in your testimony?

Mr. McGARRY. In what connection?

Mrs. KENNELLY. As a phaseout time.

Mr. McGARRY. Yes, I talked about the idea that the loan would expire, terminate in 1986, and therefore that date was of importance to us. If we had our wishes, we would like to see the program continued at least to that point.

Mrs. KENNELLY. I heard today and, Mr. Chairman, I certainly will check it, but I heard that Treasury said on the Senate side that a July 1, 1985, date was not out of the question for them.

Mr. STARK. Would the gentlewoman yield on that point?

Mrs. KENNELLY. Certainly.

Mr. STARK. To make your day even less happy, Mr. McGarry, I heard that the Senate Finance Committee voted this afternoon to cut it off this summer.

Mr. McGARRY. I am sorry, I did not hear that.

Mr. STARK. To end it this summer, at the end of the 1984 fiscal year.

And I would just state that, to at least send you away, that it is my feeling that some kind of a phasein, as I have said to the gentlewoman from Connecticut, is in order, without trying to figure out whose fault all of this is.

I do not think there is any feeling that the practice should end now. I do not think it is the committee's intention to punish anyone, and so I think we will look for a solution that is as equitable as can be. But the Senate has sort of set a short time leash on this, and that may have to get negotiated in conference. But I would say somewhere between July 1984 and the end of 1986 is where the phaseout might come, but I know not where at this point.

And to the extent that you can send us as much detailed information as you and your suppliers and the other distillers are willing to divulge, even if it has to be confidential, my feeling is that the quicker everybody can get hold of the information, the easier it would be for everyone to use that date as a cutoff date and be quick with it.

That is not a promise, but it certainly would help us, and the more candidly you could disclose to us and the more quickly this could get wrapped up, why, I think it would make Mrs. Kennelly and her constituents happy, and Mr. Moore and his constituents happy, and perhaps even placate the Government of Puerto Rico a bit.

Thank you for yielding.

Mrs. KENNELLY. Mr. Chairman, I had heard the 1984 date too, but I kind of preferred to talk about the 1985 date. Anyway, Mr. Chairman, I have no objections to ending this program, as I said to you, and we have talked this over. However, it does seem fair that we attempt to work out a reasonable transition so that people do not get hurt unfairly.

And I thank you for your patience in constantly listening to my concerns, and I enjoyed hearing the testimony of various people and I can certainly understand this gentleman's problem. They told you you could not get into the program, but it just seems that those that were told they could get in should not have to lose their investments and lose their brand.

But I thank Mr. Stark for his patience, because we have discussed this at great length.

Mr. Stark. Mr. Moore.

Mr. Moore. Mr. Chairman, I am not sure how much to get involved in this. I do not really have a constituent involved. I am concerned very definitely about the market dislocation. There seems to be some dispute about that.

But I take it everybody is agreeing now, from what I am hearing, the members of the committee at least, that we are talking about ending the program. The question is when. Nobody else gets in, everybody that is in now gets out. Is that my understanding? At least that is the way I am taking this, and the question is when do we end it.

If that is the case, then I think we are more than halfway home to determining how this legislation should operate, and that is the way I would like to proceed.

But I would like to ask Mr. Bordeaux if he would be a little more explicit in outlining for us how he perceives the market dislocations to be taking place. I think anybody who, obviously, gets their alcohol at a cheaper rate can undercut competition. I assume that is where the dislocation comes from.

Mr. Bordeaux. Right. In all honesty, the problem that really existed here and why BATF was not able to stop it was that the size of the program was really never indicated. In the present budget of Puerto Rico they are talking about redistilling 39 percent of all the neutral grain spirits produced in the United States, which is a substantial amount of about 23 million proof gallons in a marketplace that uses roughly 60 million proof gallons.

So someone could have an advantage in the marketplace of 23 million proof gallons and it is a very, very strong position, and this money that they get on the advantage can be used in various ways.

Mr. Moore. Mr. McGarry, where are you now in the $5 million loan? How much of that has been paid back?

Mr. McGarry. None of it.

Mr. Moore. What is the payment schedule on the loan?

Mr. McGarry. The payment schedule of the loan was to terminate and we were to be repaid by the end of 1986, in a lump sum.

Mr. Moore. A lump sum payment at the end of 1986, including interest at 2 percent below prime?

Mr. McGarry. Right.

Mrs. Kennelly. Will the gentleman yield?

Mr. Moore. Yes.

Mrs. Kennelly. Mr. McGarry, is it my understanding that if, just take the worst possible case, what happened this afternoon in the Senate happens, and I think that is the worst possible case, then the distillery would go out of business? Am I to understand that that is what you think would happen?

Mr. McGarry. That is the information that we have. We were at that point once before, and that was the occasion on which we loaned them the money. If at this point—and the loan, of course, was based on the fact that they would get on a financial footing. And if the program were aborted at this time, it is my understanding that the Serralles Distillery would be in great trouble.

Mrs. Kennelly. I thank the gentleman from Louisiana.

Mr. **Moore**. Certainly.

Mr. McGarry, what is the security for that loan again?

Mr. **McGarry**. We have secured it with a supply of rum in what we call an aging rum inventory in Puerto Rico.

Mr. **Moore**. Does that inventory exist?

Mr. **McGarry**. Yes, it exists.

Mr. **Moore**. Does it exist sufficient to cover the $5 million loan?

Mr. **McGarry**. Well, that is questionable. Let me explain that. This is rum in its relatively raw state, and it has to be processed and it would have to be processed through the Serralles Distillery with their formula in order to produce the Don Q rum brand. And if their distillery were not in operation, you would put that whole inventory in jeopardy.

Mr. **Moore**. But the inventory would still have some value?

Mr. **McGarry**. Yes, but I do not think we could value it.

Mr. **Moore**. Are you a privileged creditor on that inventory of rum? Are you the first creditor, the first in line for it?

Mr. **McGarry**. Yes.

Mr. **Moore**. Our colleague Mr. Corrada was here. It is not our privilege to call him back, I guess, but I understood this morning—and Mr. Serralles, you can answer this question. This morning I got the impression from your Governor that the legislature had something to do with limiting how many companies can come into Puerto Rico and take advantage of this program. Did I understand him correctly?

Mr. **Serralles**. Not exactly; sir. In other words, the legislature approves the amount of incentives that can be paid out for a whole series of programs, amongst them the redistillation program.

Mr. **Moore**. That is the way I understood it.

Mr. **Serralles**. And essentially, that amounts to about the equivalent of the available capacity that exists in Puerto Rico. So essentialy—and we are 80 percent of that idle capacity, so therefore we are basically the substantial part of the program as far as the local distiller, because essentially nobody was going to set up a distillery on a 1-year program.

In other words, the legislature approves the funds every year, so therefore from that end essentially it was available for present distillers, because nobody else requested putting up a distillery.

Now, what people are talking about getting into the program is buying alcohol. Now, the buying of the alcohol—we sell at the same price that the Midwest companies sell to large consumers, which is changed every month based upon the price of grain. And we pay the Heublein firm 35 cents for their expenses.

Now, I just mentioned in my testimony that 35 cents, even if it all was profit, which it is not because, as Mr. McGarry mentioned, they have a series of expenses to carry out the program. The advantage that they might have is whatever cents are not strictly for costs or direct costs, and that would be the only advantage that anyone would have.

Now, no one else other than Heublein and DCL, that recently started on the program in January, contacted us that they were interested in buying from us. Mr. Bordeaux has told me that he tried to call me on the phone to see whether he could buy from me, but we never talked.

Mr. Moore. Let me get back to my question. Is what you are telling me that 100 percent of the capacity is now being used and therefore there is no more capacity for anybody else to get in on the program, is that correct?

Mr. Serralles. That is correct.

Mr. Moore. Now, when did the legislature in Puerto Rico first pass the incentives to make all of this possible?

Mr. Serralles. Let me see. It was some time in 1982, and the program started I believe in December 1982.

Mr. Moore. When did you arrange your loan with Heublein?

Mr. Serralles. I arranged the loan, it was December 1981.

Mr. Moore. A year before this program went into effect?

Mr. Serralles. That is correct. But we already had contacted Treasury and this was part of the program of products that the distillery would sell to the Heublein Co. In other words, remember, that ruling started back in 1976 and the first rulings of my tenure were in 1981, at the beginning of 1981.

So toward the end of 1981 we already knew what Treasury considered to be product of Puerto Rico, and we reached an agreement with the Heublein Co. in December 1981 to carry out the program, but it really was not until the end of 1982 that the program really got off the ground.

Mr. Moore. That is when the legislature passed the incentive?

Mr. Serralles. Some time in 1982, the legislature passed the law for the 1982–1983 period.

Mr. Moore. Then it is, or it would be your testimony, I assume, that part of the consideration or part of the grounds for this loan, or Heublein's interest in the loan, was this program?

Mr. Serralles. No, it was the Don Q brand.

Mr. Moore. It was, pardon?

Mr. Serralles. The right to distribute in the United States the Don Q brand.

Mr. Moore. Were they willing to lend you $5 million at 2 percent below prime just for the right to sell Don Q rum?

Mr. Serralles. And buy from us grain neutral spirits, yes.

Mr. Moore. Under this program.

Mr. Serralles. Under this program.

Mr. Moore. So if there had not been this program, Heublein would have had no interest in making such a loan to you?

Mr. Serralles. Well, I do not know. I mean, they would have to answer that.

Mr. Moore. Mr. McGarry, why do you not answer that?

Mr. McGarry. Well, as I have said and as Mr. Serralles has said, we have a very prime interest in the Don Q brand, and whether that figure would have been $5 million in loan or not, I cannot answer that now. But certainly we would have been interested in making certain that the Serralles Distillery operated and continued to operate.

Mr. Moore. What I am trying to get down to is just how valuable the Don Q brand is.

Mr. McGarry. Well, we have invested $30 million in it.

Mr. Moore. I am trying to separate whether you invested in that brand or whether you invested in the right to participate in this program.

Mr. McGarry. Let me explain. The $30 million figure represents the kind of investment that we have invested in the advertising, merchandising, and promotion of that brand in this country.

Mr. Moore. OK, but let us get back to the fact. You made a $5 million loan that you testified to, and Mr. Serralles has acknowledged that that is the case—a $5 million loan at below market rate. That cost your company something. As you said, there was even some risk involved as to whether you would get paid back everything, although you did have some security for the loan.

My point of view is, why did you make that loan? Did you make it because you were in a bidding war with other people in the United States for the Don Q rum, or was it because of the fact that you may have been in a bidding war as to who was going to be able to participate in this program in Puerto Rico?

Mr. McGarry. You have to go back to the fact that we have been associated with the Serralles Distillery as a supplier relationship going back to 1968. The Don Q brand rum, incidentally, happens to be one of the leading categories of sales today. The No. 1 brand in the country today is Bacardi rum.

So quite obviously, that market was growing and very attractive to us. We had to stay in that market as a major supplier if we could. And our long association with Serralles represented that opportunity.

Mr. Moore. What is his distillery worth?

Mr. McGarry. I have no idea. Maybe Mr. Serralles can answer.

Mr. Serralles. At this point in time, I think very little.

Mr. Moore. It may be cheaper to buy it than lend them $5 million.

Mrs. Kennelly. Will the gentleman yield?

Mr. Moore. Yes.

Mrs. Kennelly. Can we just get back a minute to that 35 cents per gallon? There was some question on how much of that 35 cents is profit. How much of that 35 cents is profit, Mr. McGarry?

Mr. McGarry. How much of it is profit?

Mrs. Kennelly. Yes.

Mr. McGarry. Today, none of it. We have about $3 million worth of receivables outstanding.

Mrs. Kennelly. Where does it go if it is not profit?

Mr. McGarry. It goes for administering the program. I mean, we have done a lot of brokering, we have done a lot of—we did all the arrangements in the States relative to transportation, because we knew this market. We did all that work for the Serralles Distillery and it was covered by this fee.

Mrs. Kennelly. Maybe that is the answer that Mr. Moore is looking for, you do not get profit and it goes to administration. Why in heaven's name would you do this if you do not get anything? Answer that for him. Maybe that is the answer to the question.

Mr. McGarry. To keep Serralles alive, to keep them operating.

Mrs. Kennelly. And you get the rum?

Mr. McGarry. We get the rum.

Mrs. Kennelly. And you are full-line?

Mr. McGarry. We are buying a supply of redistilled alcohol with grain neutral spirits which is used in our products.

Mr. **Moore**. I sure wish I knew you about a year ago, when the famous Dixie Brewery in New Orleans was having a problem. We would have loved to have you come down there and lend them money and keep them in business.

Mrs. **Kennelly**. Mr. Moore, can I just get one more thing on the record?

Mr. **Moore**. Sure.

Mrs. **Kennelly**. I just want to get this on the record again to make sure we all understand it. The allegations, Mr. McGarry, are that the companies involved in the redistillation program have been able to underprice.

Mr. **McGarry**. To underprice?

Mrs. **Kennelly**. Their product, and that you have been able to expand your market share. Now, after the series of questions about the 35 cents, I would not think that is true, or is it?

Mr. **McGarry**. Let me give you the figures in Louisiana, for example. The redistilled product goes into, not into Smirnoff, which is our leading brand of vodka, but it goes into two other brands, Popov and Rolska. In the State of Louisiana, where we have been competing with Taaka, the leading brand in that market, they are outselling us at about 10 to 1.

Consequently, if you ask us if we reduce prices in that market to gain a competitive advantage, the advantage is already with our competitor. And when we reduce price you have to bear in mind that that goes right across the board. It is a national postdown of the price. It is not just in any one selected market.

Mrs. **Kennelly**. So there is no dislocation?

Mr. **Moore**. If I could regain my time.

I take it there is disagreement. Would you care to comment, Mr. Bordeaux?

Mr. **Bordeaux**. Well, I would like to say that we outsell them in that market, and they set a higher price, also. So not only do we outsell them, we do a little bit fancier job of selling it.

But in another marketplace where we compete, for example in Houston, Tex., in the last year our share of market is down, while the share of market for Popov has gone up, and at the same time it has become the lowest priced product in that marketplace.

Mr. **Moore**. Which you attribute to this program?

Mr. **Bordeaux**. Well, I would not like to point to it, but I say that it looks as if there are reasons of cost.

Mr. **Moore**. Mr. Chairman, I just want to conclude. I am not sure we are going to get to the bottom of all this. It is safe to say this: I think it is a mistake that Treasury issued the ruling they did. I think this committee is going to take care of that legislatively.

I think we have agreement that we are going to end the program. The question is when. What is going to be the date it ends? I think that is something we will have to resolve in the next week or so.

Thank you, Mr. Chairman.

Mr. **Stark**. Thank you.

And I would just ask, Mr. Bordeaux, I do not suppose you have any great feelings? You would probably like to end sooner than later, but 6 months one way or the other is not going to work a terrible injustice on the Sazerac Co. as long as you think that competitive fairness is restored to the market?

Mr. **Bordeaux**. Well, I think the June 30 date, which ends the fiscal year for Puerto Rico, and a cap at the present amount of money that is in the Puerto Rican budget, would be a fair compromise.

Mr. **Stark**. I appreciate your comments. I thank the witnesses for their contribution.

And I would like to call the next panel: Mr. Stephen Blake, president of the Avanti Corp. of South Bend; and Mr. J. Roger Mentz and William N. Walker as counsel of Mercedes-Benz.

Mr. Blake, please proceed.

STATEMENT OF STEPHEN BLAKE, PRESIDENT, AVANTI CORP., SOUTH BEND, IND., ON BEHALF OF ALLIANCE FOR FAIR COMPETITION IN AUTOMOBILE SALES

Mr. **Blake**. Thank you, Mr. Chairman.

Mr. Chairman and members of the Ways and Means Committee, I am Steve Blake, chairman of Avanti Motor Corp., and I am testifying today on behalf of the Alliance for Fair Competition in Automobile Sales.

The Alliance is a recently established coalition of automobile manufacturers, small businessmen, rental, and leasing companies, and automobile dealers, all of whom feel that they would suffer significant adverse effects were the proposed limitation on depreciation and investment tax credits for automobiles to be enacted into law.

To summarize as quickly as possible, Mr. Chairman Stark, although, the amendment may look like a easy, painless way to increase tax revenues and limit an area of potential taxpayer abuse, the truth is, this proposal will cause substantial injury to the still extremely tenuous recovery of the U.S. automotive industry; it undoubtedly will put many people out of work.

We have not had enough time to study this proposal. This was not on the February 1 agenda. We just found out about it only this past weekend. We would like to have more time to study the cost and benefits intelligently. Our Alliance would be happy to work with your committee on these issues.

The U.S. industry has just come out of the worst depression in history, far worse than the one in the thirties. A substantial part of the recent recovery has come from large car sales, sales of vehicles over $15,000. Because of this, I do not think what is at stake here is a tax loophole, but rather thousands and thousands of jobs. The industry depends upon a pattern of sales that are based in large part on changes made in the 1981 Tax Act.

Many of leasing companies, many rental car companies, and many of our own manufacturers are starting to get healthy again. I emphasize starting.

We are a small manufacturer. We are sometimes called the smallest automobile manufacturer in America. I have had the pleasure of being at the helm for only about a year and a half. When I took over in 1982 this was a dying firm. The growth that has occurred since then is due in part to the benefits of the Tax Code.

We are not unique. The increase in automobile sales in the United States in the last 2 years has come in large part from large car sales. For example, Cadillac and Lincoln sales have gone up approximately 50 percent from 1982 model year to 1983 model year. Using an average price of $15,000, that is about $3 billion in sales. If you take the industry average on the percentage of the price that represents labor—20 percent—you are talking about $600 million in labor. I do believe that a large portion of this would not have been spent on labor had those cars not been sold.

There are two points here. First, we have not had enough time to study intelligently the impact of the amendments; second, I think that many small businesses like ourselves and some of the manufacturers I am speaking for would be hurt significantly were this bill to be enacted.

Those of us who will be affected have had less than 2 weeks to prepare. We would ask at least for some more time to reply in an intelligent and informative manner.

Just how would this affect us? We are a little company in Indiana that employs approximately 150 people. Our employment has grown significantly, in an area in which unemployment is in the 25 percent range. I know that 50 percent of our sales are leases. One of the benefits of a business lease, of course, are the tax benefits. I think our business as well as the luxury car business in the United States would be hurt significantly.

There is nothing before this committee indicating who would be hurt were the proposal enacted and what the magnitude of that harm would be. I believe time is needed to study this. We believe that the cost of this legislation far outweighs the benefits to Treasury. I believe the revenue numbers before the committee were based on prices of $15,000 and up. Projected revenues are about $100 million. The incremental increase in U.S. luxury car sales last year amounted to over $3 billion. If one-third of these sales were to people using the car for business purposes and took the full investment tax credit, you would have your $100 million.

I believe that the potential abuse is far less than what we are talking about. I know the people who buy our product, and I know our product. We get the cars back after 3 or 4 years, and they are well used. Customers are using them for business. Other large cars are also used for business purposes. I do not think that the $100 million revenue figure is correct. I do not know the right number. We have not had enough time to study it. I have not seen the data behind the $100 million figure, but just the incremental increase in U.S. luxury car sales in 1 year was over $3 billion.

So, I do not think we have enough facts today to make an intelligent evaluation of what the revenue would be to Treasury. All I ask is that you consider the potential unemployment that this might cause, and the harm to rental companies and lease companies that have proliferated over the past 3 years. This growth has been based upon the tax benefits available.

[The prepared statement follows:]

STATEMENT OF STEPHEN BLAKE, PRESIDENT, AVANTI CORP., SOUTH BEND, IND., ON BEHALF OF THE ALLIANCE FOR FAIR COMPETITION IN AUTOMOBILE SALES

SUMMARY

There has not been sufficient study of either the tax benefits or the economic costs of the proposed limitation on depreciation and investment tax credits for automobiles.

Were the proposal enacted it could seriously undermine the recovery of the automobile industry that is now underway and, thereby, increase the already high unemployment rate in the industry.

Enactment of the proposal would have a devastating impact on many small businesses, including small American manufacturers of automobiles, businesses which supply automobile parts, automobile dealers and leasing companies.

The proposal singles out and discriminates against a single industry and will inevitably produce economic distortions as business funds now spent on automobiles are diverted to the purchase of other property.

STATEMENT

Mr. Chairman and members of the Ways and Means Committee, I am Stephen Blake President of Avanti Corp. I am testifying today on behalf of the Alliance for Fair Competition in Automobile Sales. The Alliance is a coalition of automobile manufacturers, small businessmen and automobile dealers, all of whom would suffer significant adverse effects were the proposed limitations on depreciation and investment tax credits for automobiles enacted into law.

The Alliance has a unique perspective on the proposed legislation that, we believe, will help the Committee understand what is really at stake in this proposal. Although this amendment may look like an easy, painless way to increase tax revenues and limit an area of potential taxpayer abuse, the truth is that this proposal will cause substantial injury to the still tenuous recovery of the automobile industry, will undermine many small businesses, and will undoubtedly put many people out of work. We urge the members to remember that what is really at stake here is not a tax loophole, but rather thousands of jobs and small businesses that depend upon a pattern of sales and production that has grown up partially in response to the current tax code provisions. These include businesses which supply automotive parts and services as well as businesses which rely heavily on the direct use of automobiles.

I wish to concentrate on two points—one procedural and one substantive. First, we believe that the procedure by which this proposal has come before the Committee has not been adequate or fair; second, we believe that the substantive economic effect of this proposal, were it to become law, would be to produce economic costs far in excess of the very limited tax revenue benefits that it would yield. The two points are, of course, interconnected: Because the procedures have been so hasty, there has not been sufficient study of the true economic costs and benefits that this change would produce.

Procedurally, we believe that the Committee has acted in a manner that does not allow fair and adequate consideration of the proposed change in the tax treatment of automobiles used for business purposes. This proposal was not included within the scope of the Committee's February 1 hearing notice of issues before the Committee. The first public notice that this proposal would even be on the agenda of these hearings was on Friday, February 17 when the Joint Committee on Taxation released a study of the proposals scheduled for consideration at this hearing. This has given those of us affected by the proposal less than two weeks to respond in an informative and intelligent manner. This simply is not adequate.

Many members of the Alliance will be severly affected by enactment of the change—undoubtedly many will be put out of business or otherwise forced to reduce the size of their operations. This, in turn, will affect thousands of employees. Yet the interested businesses have had no time to develop the hard data needed to demonstrate beyond doubt that the costs of this proposal will far exceed its benefits. They have had no time to work with the Committee staff in order to analyze the effects of the proposal, develop alternatives, and compare the costs and benefits of such alternatives.

Neither has the Committee had time to pursue any serious study of the effects of the proposal. There is nothing before the Committee indicating who would be hurt were the proposal enacted and what the magnitude of ths harm would be. The only indication of benefits is a single line entry in the February 23 preliminary summary of revenue increase options published by the Senate Committee on Finance. The summary indicates possible revenue increases from the proposed change of $100 million per year for each of the next four years. This entry, however, does not indicate the basis for these predictions or the source of the potential revenue. It does not, for example, indicate whether the figures reflect the decline in sales that will inevitably result form a change in the tax treatment of automobiles. Furthermore, the summary does not reflect any consideration of alternative possibilities.

More importantly, however, the revenue numbers are based on the $15,000 limit contained in the present version of the proposed change. This $15,000 figure is entirely arbitrary; it sweeps within its scope, for example, far more American-produced than foreign-produced cars. Were the Committee to raise this figure in order to exclude most domestic automobiles from the limits, the revenue raised from this proposal would be drastically reduced. It is our belief that even the current revenue figures are insignificant, when compared to the costs. The basic point, however, is that no one knows. Under these circumstances no reasoned or intelligent judgment can be made. Accordingly, the Committee, if it is truly interested in pursuing a change in this area, should set a reasonable timetable during which the staff and the Alliance can work together to develop the benefit and cost analyses needed before conclusions can or should be reached.

Substantively, I would like to give you some idea of the jobs and businesses that will be affected by enactment of this proposal. My own business, Avanti Motor Corp., is a good example. Avanti manufactures automobiles in South Bend, Indiana. At the time I took over the company in October 1982, the company was producing 200 cars a year. It had remained stagnant for 20 years. In 1983, we raised production to 280 cars; we are now producing 400 cars a year. The company in short, is thriving, as are its more than 120 employees. This proposal threatens all that we have accomplished in the last two years; its impact on my business would be devastating.

Avanti is not the only small manufacturer of quality automobiles in America. Companies of similar size produce unique automobiles in Milwaukee, Wisconsin and in Pompano Beach, Florida. These companies are small enough that even the loss of a small percentage of sales would have a devastating impact.

The $15,000 limit in the proposed change, moreover, will affect far more than simply America's small manufacturers of automobiles. The $15,000 will sweep in much more than so-called "luxury" cars: Vans, stationwagons and many sedans now carry price tags of over $15,000. Furthermore, the Committee should understand the major role that the more expensive automobiles have played in Detroit's recent recovery. For example, in 1983, more than 400,000 Cadillacs and Lincolns were sold in this country; up dramatically from the 240,000 sold in 1982. As is common knowledge, the industry makes a far larger profit—both in real terms and as a percentage of price—on the sale of these so-called "luxury cars." We would suggest that the health of the domestic automobile industry and, consequently, the improvements in its unemployment figures are still far too sensitive to withstand the blow that this seemingly minor change would effect. Moreover, any attempt to cure this "effect" of the proposed legislation by raising the $15,000 limit in order to exclude most American cars would likely violate the provisions of GATT, The General Agreement on Tariffs and Trade. This is another area that requires further study.

Finally, I want to mention all of the automobile dealers, companies in the leasing business and repair shops that will be affected by this proposal. Even imported cars produce domestic jobs from the minute they get off the boat. Enactment of the proposal would affect all these businesses across the country, from new car dealerships to repair shops, from leasing companies to used car lots. While we do not yet have the hard numbers required to demonstrate the real costs of this proposal, this is by no means a reason to rush forward to passage. Rather, it is a reason to wait, to allow time for the study needed to produce the hard data that should guide a decision.

This proposal singles out and discriminates against a single industry. Inevitably economic distortions will result as business funds which would otherwise be spent on automobiles are diverted to purchasers of other property. The automobile industry which was one of the most severely hit by the recent recession surely does not deserve to be singled-out by this Committee as the target of this legislation.

Accordingly, I urge you to strike the proposal to limit the investment tax credit and the ACRS deductions to the first $15,000 of the cost of a passenger automobile. The Alliance is ready to work with the staff in order to develop the information on costs and benefits that is required in order to give fair consideration to this or similar proposals. To act in the absence of such information will produce costs to workers and small businesses far in excess of the possible tax revenue benefits. Furthermore, the benefits envisioned are of far too small a magnitude to justify a rush to judgment and an absence of fair procedures for those of us who will suffer the consequences of this change.

I am very grateful for the opportunity to testify before this Committee and would be happy to answer any questions you may have.

Mr. STARK. Thank you, Mr. Blake. The UAW tells us it takes just as many man-hours to build a $15,000 car as it does to build a $50,000 car, so they have no objection to the bill, and one presumes that the people who need the car are going to buy a car, and so that in the question of unemployment, while on a microbasis it may be a problem, it certainly is not an impact on our country. It is employment.

Now, Mr. Mentz and Mr. Walker, you have a joint statement here. You are accompanied by Mr. Walker. Whichever one of you wants to summarize. Your full statement will appear in the record.

STATEMENT OF J. ROGER MENTZ AND WILLIAM N. WALKER, COUNSEL, MERCEDES-BENZ OF NORTH AMERICA, INC.

Mr. MENTZ. Thank you, Mr. Chairman.

First, I want to congratulate you on your endurance.

Mr. STARK. Well, I would congratulate Mercedes-Benz on their endurance. I have owned several of them, and I find that they seem to run forever.

Mr. MENTZ. Well, I am very glad to hear that.

I am here today with my partner, Bill Walker, both of us from Mudge Rose, and we are counsel to Mercedes, to testify on H.R. 4135.

The United States is the largest export market for Mercedes-Benz automobiles, and as you just attested, their success is attributable at least in large part to the superb quality of the product, and also to the very capable management responsible for the U.S. distribution business where over 10,000 people are employed.

H.R. 4135 would limit the tax benefits on passenger automobiles used for business purposes to the first $15,000 of cost, as you well know. I will address the tax policy aspects, and my partner, Bill Walker, who was Deputy Special Trade Representative and Ambassador and head of the U.S. delegation to the Multilateral Trade Negotiations in Geneva, will handle the trade side. I will try to keep it quite brief.

Mercedes' position is that as long as the tax rules are fair and nondiscriminatory, it can compete effectively in the U.S. market and continue to make its contribution to the Federal Government's revenue requirements, a contribution which has been very substantial in recent years. In fact, I would point out to you that in recent years the Federal income taxes paid by Mercedes-Benz exceed the revenue estimate that we are talking about here for this bill.

Mercedes, obviously, has a serious problem with the bill. This bill would only affect cars whose retail prices exceed $15,000 and would deny all tax benefits on the excess. In this form, Mr. Chairman, the bill would potentially affect Mercedes in America more than any other car company in the world. I think the fair way to look at this is the amount of tax basis that is being affected, because that is the best measure of what you are really talking about.

Of total tax basis lost on all cars under the bill, 33 percent of it would be attributable to Mercedes, as I said, more than any other company, and yet Mercedes' unit sales in the U.S. are not even 9 percent of the total. The imports as a whole would suffer. The amount of basis lost would be $1.129 billion more than all domestics. Indeed, the German companies in particular would bear the brunt.

It turns out that German exports to the United States would have more tax basis lost than any other country, including the United States, in total, which is a rather shocking figure. On a comparative basis, the importers would bear 63 percent of the total tax burden, even though their unit sales were less than 40 percent.

Now, we have got two problems with this bill, Mr. Stark. First of all, it would single out one product, passenger cars, for discriminatory tax treatment on sort of a personal benefit theory. Now, if you are going to look at this personal benefit theory, and I am not saying not to, but if you——

Mr. STARK. I am looking at your testimony on page 3. And that you have to exclude there, because meals, entertainment, the rental of hotel suites and business apartments—aircraft qualifies, air travel does not, country clubs do not, office furnishings might—do not have the investment tax credit or do not qualify for it, and I am going to take your testimony, as Senator Moynihan and I agreed this morning, and consider amending these things to the bill.

I think you make a very good case that I see no reason why fancy furniture and oriental rugs and that sort of thing provided for executive suites ought not to come under the same kind of limitation.

Mr. MENTZ. As you mentioned to Mr. Chapoton last week, and as Senator Bradley said, if we are going to get the automobiles, why not get the Lear jets?

Mr. STARK. You make a good point.

Mr. MENTZ. Except that the Lear [sic—should be Beechcraft] jets are made in Kansas. But I would say to you, if you are going to do this, you ought to do it in a full legislative process. You ought to hear from these folks, and you ought to figure out a way to do it, and I think maybe come up with a fair rule, and that might be very good for our tax system.

The second point, and the one what we are talking about right here, I really want to emphasize to you, is, the bill is discriminatory within the automobile industry itself. To the extent that there is a personal benefit problem with automobiles, it exists for all business automobiles, not just those priced over $15,000. A fellow who has got a Cadillac and he paid $14,000 for it, or $14,500, he is driving it to the country club, and he is driving the family to church on Sunday. The wife is driving it to the PTA meeting. It seems to me that is a tax policy problem as well, Mr. Chairman, and I would simply say to you if you are absolutely bound and determined to achieve a legislative solution on automobiles, do it in a way that is nondiscriminatory, and if you can do that, we will accept it.

These two points were specifically mentioned by Buck last week in his testimony when he expressed disapproval of the bill on tax policy grounds.

Now I would like to turn it over to Mr. Walker, who will discuss the trade aspects of the bill, if I may.

Mr. STARK. If I may, I know Mr. Walker was Trade Rep when we put the 10-percent surcharge on all imports.

Mr. WALKER. No; that was in 1971, Mr. Chairman.

Mr. STARK. But our economic crisis is even greater today than it was in 1971. So I know he favors surcharging. But I would like to make Mr. Walker's testimony part of the record. I happen to have the CRS study which concludes that significant arguments appear to conclude the compatibility of this legislation with article III of GATT.

That is based not so much on the operation of the legislation, which is nondiscriminatory on its face, and based upon available figures would affect a greater number of domestic automobiles than foreign, but it is also a fact that the legislation proposes an income tax amendment, and income taxes are generally held to be exempt from obligations of article III and are arguably beyond the purview of article III. 4. The agreement's drafting history appears to support this interpretation, which to date has not been disputed by any GATT decision.

Now, it was drafted with the particular intention of not violating any of the GATT proposals, and obviously I would be happy to give you equal time to file some kind of a brief disagreeing with that, and I would assume Mercedes-Benz would not pay you to agree with them, but I am afraid you would lose the chair in any of the legal interpretations of whether this did or did not conform with GATT.

It was the intention of the Chair when staff drafted the proposal that it would conform and it would not violate any of the GATT agreements. I would be willing to trade you this, say, for this payment, which—I mean, we have been known to violate GATT before, but I do not believe this one does.

Now, if there is anything that you can expand on that I can understand, I would welcome that additional interpretation at this time.

Mr. WALKER. Thank you, Mr. Chairman. It is nice to be back before the committee, even as anchorman on this long day. I had intended in fact not to refer to the statement which, as you have indicated, will be inserted in the record, but really to make four or five very brief comments on the Congressional Research Service study, which I got access to only last night, after I had prepared the testimony, so I was not able to address it in my prepared remarks, and I gather from your colloquy this morning with Senator Moynihan and the remarks you just made that you are relying essentially upon that study for your conclusion that there is no incompatibility between your bill and the GATT.

I have four major problems with that study, which I am frank to tell you I find inadequate and in some cases wrong. First, if the GATT does not apply to income taxes, can someone explain to me how it is that in November 1976, a GATT panel and a GATT council ultimately found that the U.S. DISC provisions and the U.S. income tax are inconsistent with GATT.

You made reference to the DISC yourself. That is an income tax provision.

Second, the Congressional Research Service study relies upon a Treasury Department general counsel's opinion.

Mr. **Stark**. I will take that on as a nonlawyer. It seems to me the DISC is subsidizing exports, and you are talking about a supposed penalty on an import, so I mean, to me one is going out and the other is coming in.

Mr. **Walker**. But the point that the study was making is that the GATT does not apply to income tax provisions, and yes, one is an export, one is an import, but we are talking about income tax provisions now, and that is an income tax provision.

Second, the Research Service study relies upon an opinion of the Treasury general counsel which appears to have been the opinion that was given when DISC was being considered, which is now rendered if not invalid, certainly highly suspect.

Third, the same argument was advanced by the domestic machine tool industry in the Houdaille petition, where the machine tool industry petitioned USTR to deny the use of the investment tax credit on machine tools imported from Japan because of allegedly unfair trade practices. You will recall that proceeding.

And the petition was denied by USTR, and during the course of that proceeding, an opinion was rendered by Mr. Gardner Patterson, who was the long-time deputy director general of GATT, to the effect that denial of the investment tax credit provision of the U.S. income tax laws to Japanese machine tool imports would violate article III of the GATT. That letter of opinion is on file at the office of the general counsel of the USTR, and your staff may wish to refer to it.

Finally, the Treasury Department has consistently taken the position that denial of the investment tax credit to purchasers of foreign produced products is a violation of article III of the GATT. In addition to the letter from Assistant Secretary Chapoton to Congressman Jones referred to in my testimony, there are a number of other letters which we would be glad to supply for the record.

So that the proposition upon which you are relying that the GATT does not reach this kind of provision, I think, is wrong, to put it in words of one syllable.

Last, Mr. Chairman, the study and some of the comments that we have heard on this bill suggest that there is no discrimination because there are more units above $15,000 that are produced domestically than are foreign, and that is in fact the case, but if one looks, as Mr. Mentz suggested, at the tax impact of this bill, it is obviously considerably more severe on the more expensive cars than it is on the less expensive cars in that category, much greater impact on a $30,000 Mercedes than on a $16,000 Cadillac.

If you looked at the total tax basis that would be affected by this provision, the imports would bear virtually two-thirds of the tax loss that would occur on less than 40 percent of the volume of units. That, I would suggest, is a substantially disproportionate impact.

[The prepared statement follows:]

STATEMENT OF J. ROGER MENTZ AND WILLIAM N. WALKER, COUNSEL, MERCEDES-BENZ OF NORTH AMERICA, INC.

Mr. Chairman and members of the committee, my name is J. Roger Mentz. I am a member of the law firm of Mudge Rose Guthrie Alexander & Ferdon. My partner, William N. Walker, and I are appearing before you today on behalf of Mercedes-Benz of North America, Inc. to testify on H.R. 4135.

Our law firm has represented Mercedes-Benz for over 25 years, during which annual imports of Mercedes-Benz automobiles to America from the Federal Republic of Germany have increased to over 70,000. The United States is the largest export market in the world for Mercedes-Benz automobiles. Their success in America is attributable to the superb quality of the automobiles and to the capable management responsible for the United States distribution business, where over 10,000 people are employed.

H.R. 4135 would limit the tax benefits (investment credit and depreciation) on passenger automobiles used for business purposes to the first $15,000 of cost.

Mr. Chairman, we will divide our testimony. I will address the tax policy aspects of the legislation while Mr. Walker will address its GATT and trade policy consequences. Mr. Walker was Deputy Special Trade Representative from 1975 through 1977 when he served as Ambassador and Head of the United States Delegation to the Multilateral Trade Negotiations in Geneva.

Mr. Chairman, as long as the tax rules are fair and nondiscriminatory, Mercedes-Benz can compete effectively in the United States market and continue to make its contribution to the federal government's revenue requirements, a contribution which in recent years has been very substantial. But Mercedes-Benz has a serious problem with H.R. 4135 as presently proposed.

This Bill would only affect cars whose retail prices exceed $15,000, and would deny all tax benefits on such excess. In this form, the Bill would potentially affect Mercedes-Benz in America more adversely than any other automobile company—ironically, Mercedes-Benz is the only automobile that offers the extra protection of air bag technology, anti-skid brakes, and certain emission control concepts. Mercedes-Benz cars would be subject to a potential loss of tax basis of 33% of the total potential basis loss for all cars, although its unit sales are not even 9% of total car sales with list prices over $15,000. All imported cars would suffer a combined potential tax penalty of lost basis of $1,129 million more than all domestic manufacturers—on a comparative basis, the importers would bear 63% of the potential tax penalty, even though their unit sales are less than 40% of the total in this category.[1]

There are two tax policy problems with the Bill. First, H.R. 4135 would single out one product, passenger cars, for discriminatory tax treatment simply because the passenger car may have some "personal benefit" although used exclusively in a trade or business. There is no question but that there is personal benefit in owning and driving a Mercedes-Benz, or indeed any car. The Bill would thus apply a tax penalty on this personal benefit inherent in the use of a business automobile, but not on any other similar "personal benefits." It would be unfair to decide, under extreme time pressure, to apply this "personal benefit" approach only to automobiles—if it is to be considered, it should be considered in the context of other items such as business meals and entertainment, hotel suites and business apartments, corporate aircraft, first class air travel (and super-first class), country clubs, office furnishings, executive dining rooms and health facilities, which raise the same problem. Only through the full legislative process can a fair solution be achieved to the overall issue.

The second problem is that the Bill is discriminatory within the automobile industry itself. To the extent that a "personal benefit" issue exists in connection with automobiles used in business, it exists for all business cars, not just those sold at prices over $15,000. If a legislative solution is considered appropriate, it must be a fair one that applies uniformly to all passenger cars.

These two problems were specifically recognized by Assistant Secretary Chapoton at the Ways and Means Committee Hearing on February 22, 1984 when he expressed his disapproval of H.R. 4135.

My partner, William N. Walker, will now explain why H.R. 4135 as presently proposed raises serious trade issues and is contrary to important United States interests.

Thank you. I am pleased to appear before this Committee once again.

H.R. 4135 would adversely affect the competitive position of automobiles sold for business use priced substantially above $15,000, a proposal that would disproportionally affect imported autos. Indeed, this point was specifically made by Senator Moynihan in his introductory remarks to his Senate version of the Bill, where he said that "it is time to stop the practice of the ordinary taxpayer subsidizing the use of luxury limousines by business executives—limousines, I might add, mainly manufactured abroad." (Cong. Rec. S472 daily ed. Jan. 30, 1984) Legislation of this kind, which has the effect of discriminating against imported merchandise, contravenes United States international obligations.

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[1] Based on 1983 figures for sales of automobiles with list prices in excess of $15,000. Since not all cars sold are used in business, it is not possible to determine accurately actual numbers for tax basis lost, but these numbers provide a general measure of the relative poteftial impact of the Bill.

Article III of the GATT forbids the levy of internal taxes or charges on imports in such a manner as to discriminate against imports or afford protection to domestic producers. This is the so-called "national treatment" clause which is, in general terms, designed to prevent governments from erecting tax or regulatory regimes discriminating against imports.

This tax legislation is not discriminatory on its face. It would apply to any automobile priced above $15,000 regardless of whether it is imported or domestically produced. However, the effect of the legislation is discriminatory because those automobiles that are priced substantially in excess of $15,000, and which therefore would incur the greatest tax penalty, are virtually all imported. Indeed, all new Mercedes-Benz automobiles sold in the United States and used in a trade or business would be adversely affected.

The discrimination is evident on its face. The average list price of domestic automobiles priced above $15,000 is $18,500, whereas the average price for imports above that level is $23,400—a $4,900 differential. Quite clearly the denial of tax benefits for automobiles above $15,000 is far more severe for the average import than for the average domestically produced car.

Based on 1983 sale figures, and assuming that all cars are sold at list price, without additional options, and that all cars sold at prices above $15,000 are used in business, the data indicate that of the potential tax basis disallowed under the Bill, 37% is represented by domestic automobiles and 63% is represented by imports even though imports account for less than 40% of total unit sales in this category. Indeed, Mercedes-Benz alone represents 33% of the total amount of tax basis potentially disallowed by the Bill. Thus the bias of the proposed Bill against imports in general, and Mercedes-Benz in particular, is dramatically clear.

These data do not present a complete measure of the consequences of the enactment of H.R. 4135, however, for several reasons. First, there is discounting of suggested retail prices, particularly on domestic vehicles. Second, suggested retail prices do not take into account the additional cost of options which many buyers will add to their cars. Thus, the list price is a meaningless guide to determining which vehicles in fact exceed the $15,000 threshold. Third, and most important, the universe of cars affected by this legislation is composed not of all cars above $15,000, but only those used for business purposes for which business tax deductions are claimed. Data are not published on the percentage of new cars purchased for business purposes, and indeed, we have been told by the Internal Revenue Service that even the IRS does not tabulate these data.

It is clear, however, that a larger discrimination would exist and that the effect of the bill would be to induce business purchasers to avoid higher-priced cars where the tax penalty would be perceived to be greater. In other words, a business buyer might not be dissuaded from purchasing a $16,000 car, but he might well be dissuaded from purchasing a $40,000 car.

There can be no doubt that if the legislation, on its face, limited the tax benefits of owning imported automobiles and did not apply equally to ownership of domestically produced cars, it would be a contravention of Article III of the GATT. Thus, in a letter dated April 1, 1982 to Representatives James Jones, the Assistant Secretary (Tax Policy), John E. Chapoton, stated that a proposal to limit the investment tax credit to purchasers of domestically produced automobiles would be contrary to the obligations of the United States under the GATT.

It is also clear that provisions which are not discriminatory on their face but are discriminatory in application and effect are also improper. Jackson, *World Trade and The Law of GATT*, 284 (1969). Indeed the United States has advanced precisely this argument in GATT proceedings. For example, in September, 1956, the United States filed a formal GATT complaint against the imposition of a French tax on automobiles having a power rating for fiscal purposes in excess of 16 horsepower on the ground that the effects of the tax would be borne disproportionately by larger and more powerful American cars. (GATT Doc. L/520, Sept. 12, 1956). Again, in November, 1956, the United States complained to GATT against a steeply graduated Chilean tax on automobiles which would also discriminate against more expensive United States cars. (GATT Doc. L/599, Nov. 16, 1956). The United States claimed in both of these cases that the taxes in question violated Article III of the GATT because of their discriminatory effects even though they were not discriminatory on their face.[2] In November 1979, the United States made this argument in complaining to the GATT concerning a Spanish consumption quota on soybean oil (GATT Doc. L/4859). While the quota applied to domestically produced soybean oil as well as the imported product, the domestic oil was largely refined from imported raw material, and the United States argued that the burden of the regulation was disproportionately borne by imports and was therefore discriminatory.[3]

The Congress has also sought to avoid contravening the GATT rules in Article III. In 1977 the Carter Administration proposed a fuel efficiency tax rebate scheme as part of its "gas guzzler" tax initiative. The rebate was to be available to imports as well as domestically produced automobiles but the rebates on imports were to be governed by executive agreements to be negotiated with the various countries of origin. The Staff of your Committee recommended this provision be deleted from the bill (and it was in fact deleted), because, among other reasons, it contravened obligations of the United States under the GATT.[4]

The national treatment obligations in Article III protect vital American interests in international trade. The United States must be in a position to assert its rights if other governments were to impose regimes discriminating—in fact, if not on their face—against such vital American exports as aircraft, computers, or agricultural products, for instance.

Indeed, precisely such an element is present right now in a potential dispute between the United States and the European Community involving United States exports of soybean products. The EC Commission has proposed to levy upon certain oils and fats a consumption tax that applies on its face both to imports and EC-produced products, but the United States claims, among other things, that the effect of the tax would be borne disproportionately by imports from the United States. While the tax applies to olive oil (mainly EC-produced) as well as other oils, application of the flat 7.50 ECU consumption tax is effectively a higher tax on lower priced imports from the United States than it is on higher priced olive oil.

The EC has not yet taken a decision on whether in fact to impose this tax, but the United States, in opposing the proposal, is making precisely the argument advanced here—that it would contravene Article III of GATT. It would be directly contrary to the United States position in this important pending matter if the United States were to pass a tax law that discriminated against imported automobiles and would invite retaliation against United States agricultural exports.

The proposed legislation also appears to contravene the Treaty of Friendship, Commerce and Navigation between the United States and the Federal Republic of Germany dated October 29, 1954, which was entered into force on July 14, 1956.

Article XVI, Paragraph 1 of this FCN treaty provides: "Products of either Party shall be accorded within the territories of the other Party, national treatment and most-favored-nation treatment in all matters affecting internal taxation, sale, distribution, storage and use." 7 UST 1839, 1857 (1956).

Article XXV defines the term "national treatment" as "treatment accorded within the territories of a Party upon terms no less favorable than the treatment accorded therein, in like situations, to nationals, companies, products, vessels or other objects, as the case may be, of such Party." 7 UST at 1865.

For the same reason that a provision discriminating against imports contravenes the national treatment provisions of the GATT, a provision discriminating against imports also violates the similar provision of this FCN treaty.

For all of the foregoing reasons, we urge that this legislation not be enacted.

Thank you.

Mr. **Stark**. I just received a letter dated the 28th from the U.S. International Trade Commission, signed by its Chairman, Mr. Eckes, and I intend to make the full letter part of the record.

[The letter follows:]

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[2] The U.S. complaint to the GATT on the French road tax was never resolved, but the tax was repealed as part of concessions made by the European community in the Kennedy Round. (GATT Doc. L/2819, July 17, 1967). The Chilean tax was also repealed after GATT consultations between the U.S. and Chile and in April 1957, the U.S. requested no further GATT action be taken on the matter (GATT Doc. IC/SR.31 April 24-27, 1957).

[3] The GATT panel on the U.S. soybean oil complaint ruled against the U.S. on other grounds. The panel's report has not been approved by the GATT Council.

[4] Energy Tax Proposals Relating to Transportation prepared for the House Committee on Ways and Means by the Joint Committee on Taxation, p. 35, June 6, 1977.

U.S. International Trade Commission,
Washington, DC., February 28, 1984.

Hon. Fortney H. Stark,
Chairman, Select Revenue Measures Subcommittee, Committee on Ways and Means, House of Representatives, Washington, D.C.

Dear Mr. Chairman: Thank you for your letter of February 16, 1984, requesting our advice concerning whether your bill, H.R. 4135, which would limit tax writeoffs on automobiles to the first $15,000 in basis, violates the GATT.

The Commission is not charged with overseeing our GATT obligations. While the Commission is familiar with these obligations, can provide background information concerning them, and can flag potential GATT problems posed by pending legislation, it would be improper for us to render advice concerning whether a bill violates GATT. The agency most directly concerned with our GATT obligations and in the best position to render such advice is the Office of the U.S. Trade Representative.

Your bill involves internal taxation and, in effect, imposes a luxury tax on expensive automobiles. Our basic GATT obligation concerning internal taxation is set forth in Article III, paragraph 2 of the GATT as follows:

"The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products. Moreover, no contracting party shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1."

Complaints brought under GATT indicate that luxury taxes are subject to Article III. Such taxes cannot be applied in such a way as to discriminate against imported goods. Taxes that are general, uniform, and have a revenue purpose are generally consistent with GATT, but disguised attempts to discriminate against imports would violate our Article III obligation. (For a further discussion of these concepts, we suggest that you see J. Jackson, World Trade and the Law of GATT (1967), at pp. 279-86.)

Thus, the intent and effect of the legislation appears to be key in determining whether the legislation is consistent with GATT. If it has the intent or effect of imposing a heavier burden on imported automobiles than on domestic automobiles, the legislation may raise GATT problems. Many of the makes of automobiles cited in the Congressional Record statements attached to your letter as examples of alleged writeoff abuses are imported. In addition, an estimated 40 percent of the automobiles retailing at over $15,000 sold in the United States in 1983 were imported versus only about 25 percent of the automobiles retailing at under $15,000. Most of the imported models retailing at over $15,000 were imported from the European Community, particularly from West Germany, and they accounted for a large share of the automobile imports from that source. These facts could lead some to assert that the bill is directed against imported luxury cars, particularly those from West Germany and elsewhere in the Community. However, if the intent and effect of H.R. 4135 is to prevent excessive writeoffs for automobiles rather than to reduce imports, the bill ought not to violate Article III.

If we can be of further assistance in this or any other matter, please do not hesitate to call upon us.

Sincerely,

Alfred Eckes, *Chairman.*

Mr. Stark. To summarize it, in the second from last sentence, he talks about how many cars come from West Germany under this import of this bill, but he said, "these facts could lead some to assert that the bill is directed against imported luxury cars, particularly those from West Germany and elsewhere in the Community." However, and I guess this is the key sentence, "if the intent and effect of H.R. 4135 is to prevent excessive writeoffs for automobiles rather than to reduce imports, the bill ought not violate article III."

Signed, and he talks about some taxes, but I gather he is suggesting that we do not violate it, and it certainly was, as I say, not our intention, and I think our intention was and is to allow American business people to use automobiles for their business, which is why we give them investment tax credit and a deduction. We do not give them a deduction to race them. We do not give them a deduction to pick up girls when they drag the main on Saturday night.

They have to be used for a business purpose. And the $15,000 that has been raised and the $15,000 is adequate to purchase a large size American four-door sedan with all of the necessary power-assisted safety equipment to adequately transport five adults hither and yon, in some questionable safety and with questionable economy, but at least the best that our domestic producers are able to produce.

The unions have told us it takes as many employee hours to produce one of those as it does one that maybe cost $20,000 or $25,000, largely Cadillac and Lincoln. They do not seem to be objecting to the bill. By that I do not mean to damn them with faint praise and suggest that they endorse it, but it is not—so that it does, unfortunately, fall on Mercedes.

But I would say to you that as a person who perhaps, looking about, probably owned more Mercedes than anyone in this room in his lifetime, I can vouch for their superiority, and I know of no other reason to pay that outlandish price for them, except if you happen to enjoy a highly overengineered, marvelously produced, dependable product which has a marginal increase in safety and economy and comfort over anything America has seen fit to produce in the past 50 years.

And I do not happen to be able to deduct the expenses of owning these outrageously expensive cars, but I dearly love them, and I suspect that is why most people buy them. There could be no reason to suffer the discomfort of getting in and out of a 380 SL, say, on a cold, slushy winter day, unless you love to ride around in it, and your image was increased by being seen in it.

So, I predict that Mercedes will, as they have since the turn of the century, continue to produce the best automobiles in the world, the best luxury automobiles in the world, I guess, and my bill will not affect them one way or the other. The guy who is going to buy a Mercedes will continue to. He just will not bite off quite as much, and he may drive it a little longer, but now, with the introduction of the baby Mercedes, you are coming to within where most people could get—I do not know what the base on that is, but I would imagine the base on that is pretty close to $15,000, so you will able to include the 190's in this, and Mercedes is then home free.

Mr. WALKER. Just one last comment, if I may, Mr. Chairman. We do appreciate your endorsement.

Mr. MENTZ. Yes, and in fact we are going to have our marketing people get ahold of the record and circulate it widely. [General laughter.]

Mr. WALKER. But the point that we would make——

Mr. STARK. I want to tell you the newspapers in my district have already done that for you, every chance they get. [General laughter.]

Mr. WALKER. The last point we would make is simply this, that if you were to do as Mr. Mentz suggested and as you yourself have suggested, take the same approach with a whole range of so-called luxury goods, and not single out automobiles, then there would be no GATT argument. There is a GATT argument, and a serious threat of retaliation against action in contravention of GATT simply by virtue of the fact that you have selected one commodity.

Mr. **Stark**. What do you mean, retaliation?

Mr. **Walker**. We are today confronting exactly the same situation.

Mr. **Stark**. Every country—Japan has a big car tax. France has a big car tax. I mean, they are all taxing on weight and horsepower and size, which certainly is tough on our Cadillacs and Lincolns.

Mr. **Walker**. But in none of those cases, Congressman, do you find a situation where the bulk of the products that are hit by that tax are imports.

Mr. **Stark**. They would be if we could sell any of them.

Mr. **Walker**. That is a different question, but the fact of the matter is that that is not the situation. In fact, we complained about the French road tax 15 years ago and got a concession from them in the Kennedy round, where they made just the argument you are making. The point is, we are making arguments against the European Community in agricultural areas and potentially in other areas that facially nondiscriminatory but discriminatory in fact taxes contravene GATT, and so we are, I would suggest, shooting ourselves in the foot on this one.

Mr. **Stark**. Well, as I say, you certainly sound convincing. If I understood the legal ramifications of what you were saying, I might be able to comment on whether you would convince the judge and jury, but as I am mostly chairman by default today, I will make sure that your entire statement appears in the record, and I suppose that the Supreme Court or the next GATT round will decide who is right on the issue if the bill survives.

Mr. **Walker**. If I may, I would like to take you up on your offer as well to submit a statement.

[The following was subsequently received:]

MUDGE ROSE GUTHRIE ALEXANDER & FERDON,
New York, N.Y., March 1, 1984.

Hon. FORTNEY H. STARK,
Longworth House Office Building,
Washington, D.C.

DEAR CONGRESSMAN STARK: This is in repsonse to your invitation at the Ways and Means Committee hearing on February 28 to respond to the Congressional Research Service study on the compatibility of H.R. 4135 with GATT national treatment obligations, dated February 21, 1984 (hereinafter the CRS study) and the February 28, 1984 letter to you from the Chairman of the International Trade Commission commenting on the same subject.

The CRS study, insofar as it concludes that all income tax provisions are exempt from GATT national treatment obligations, is a serious oversimplification. It is true that there is some dispute over the question of which border tax adjustments are governed by Article III and that some distinctions are properly made between income taxes and excise taxes. But it is incorrect to conclude, as the CRS study suggests, that a blanket Article III exemption applies to income tax provisions.

The CRS study relies heavily upon the GATT drafting history in its reasoning. However, the distinction between income and excise taxes which is reflected in the historical records was based upon the assumption that adjustments in income taxes do not affect trade neutrality because, unlike excise taxes, income taxes are not shifted forward into final product prices. Those long ago assumptions have been largely discredited by changes in tax systems and economic theory during the past 35 years. Indeed, the United States has taken the lead in challenging the validity of those earlier assumptions in the GATT Working Party On Border Tax Adjustments between 1968 and 1970.

Dr. Gardner Patterson, the retired former Deputy Director of the GATT, addressed this question in a letter dated August 26, 1982, submitted on behalf of respondents in connection with the *Houdaille* petition filed under section 301 of the Trade Act of 1974 as amended before the Office of the United States Trade Representative.[1] Dr. Patterson reviewed the changing attitudes towards the prior assumptions and pointed out that disagreement continues on the issue of whether and to what extent income tax adjustments are shifted forward into commodity prices. But he states that agreement on this complex question is not necessary

"because all parties agreed, both in the GATT preparatory work and in this most recent complex examination that the *purpose* of the GATT rules on tax adjustments applied to goods entering international trade was to ensure "trade neutrality", or in the words of Professor Jackson, ". . . to equalize domestic tax treatment on goods consumed domestically whether domestically produced or imported . . ." Indeed, the last sentence in the Working Party's final report states that the tax adjustment provisions of the GATT ". . . were precisely designed to ensure equal tax treatment as between foreign and domestic products." (Footnotes omitted.)

Dr. Patterson noted that "this fundamental point [trade neutrality] is made repeatedly" in the report of the GATT Working Party on Border Tax Adjustments.

This notion of trade neutrality is an important component of national treatment. The CRS study suggests that the only inquiry which need be made is whether or not a particular provision falls within the income tax law and that if the answer is yes the measure is exempt. As Dr. Patterson's analysis suggests, both the question and the answer are mistaken. Instead, the proper question is whether a border tax adjustment is trade neutral or not; if it is not, Article III considerations may come into play.

Moreover, the particular tax provisions affected by H.R. 4135 represent an easier case than some other income tax provisions might because they relate directly to products: depreciation and the investment credit are both product-specific. In both cases the applicability of the tax provision arises upon purchase of a product and the amount claimed depends upon the purchase price. The product price would be affected by the reduction in tax benefits, thereby quite obviously violating the trade neutrality principle if applied in a discriminatory manner. While the specific provisions are, respectively, deductions and credits, analytically they are identical to taxes and thus fall squarely within Article III(2).

Finally, the Treasury Department has repeatedly taken the position that denial of the investment tax credit to imported property, while granting it to domestically-produced property, is in clear contravention of GATT Article III obligations. You will recall that I referred in my testimony to a letter dated April 1, 1982 from Assistant Treasury Secretary Chapoton to Congessman Jones delcaring specifically that limiting the investment tax credit to purchases of domestic automobiles would squarely violate GATT. Other such letters can also be furnished for the record.

As the foregoing analysis indicates, there are serious flaws in the CRS study and it is squarely at odds with previous statements of U.S. policy. We therefore urge the Committee not to rely upon the CRS study as grounds for assuming that H.R. 4135 is not obliged to meet GATT Article III standards.

Turning now to the ITC letter, the comments of Chairman Eckes simply beg the question. Does the effect of H.R. 4135 discriminate against imports in such a fashion as to afford protection to domestic industry? If so, there is a GATT problem, if not there is not a GATT problem. The Chairman's letter and the CRS study both fail to address the discriminatory tax impact of the bill. Obviously the effect of this bill will be far more severe for the business purchaser of a $30,000 Mercedes—who stands to lose $15,000 in tax benefits—than it is for the purchaser of a $16,000 Cadillac—who stands to lose only $1,000. In fact the figures show, in terms of total lost tax basis, that *imported cars would account for almost ⅔ of the lost basis on less than 40 percent of the unit volume.* I am attaching a table which graphically makes this point and I submit that a disproportionate tax effect of this magnitude constitutes a clear case of discrimination contravening GATT Article III.

I repectfully request that this letter be made a part of the hearing record.

With best wishes.

Sincerely,

WILLIAM N. WALKER.

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[1] This document is available for inspection at the Office of General Counsel at USTR.

1983 COMPARISON—DOMESTIC AND FOREIGN

Manufacturer/model	Price	Price minus $15,000	Sales	Excess tax basis
DOMESTIC				
Buick:				
Riviera—2-door coupe	$15,238	$238	50,613	$12,045,894
Riviera—2-door T type	15,906	906	994	900,564
Riviera—2-door convertible	24,960	9,960	1,739	17,320,440
Cadillac:				
DeVille coupe	15,970	970	60,300	58,491,000
DeVille sedan	16,441	1,441	70,423	101,479,540
El Dorado coupe	19,334	4,334	71,624	310,418,420
Fleetwood brougham coupe	18,688	3,688	5,200	19,177,600
Fleetwood brougham sedan	19,192	4,192	38,300	160,553,600
Seville sedan	21,440	6,440	33,522	215,881,680
Oldsmobile: Toronado brougham coupe	15,252	252	41,791	10,531,332
Chevrolet: Corvette hatchback coupe	21,800	6,800	28,144	191,379,200
Total:			402,650	1,098,179,270
Chrysler:				
LeBaron Mark Cross convertible	15,595	595	2,269	1,350,055
Imperial 2-door hardtop	18,688	3,688	1,237	4,562,056
Total			3,506	5,912,111
Lincoln:				
Town car 4-door	17,139			
Town car 4-door Signature	18,481			
Town car 4-door Cartier series	19,817			
Average price	18,479	3,479	59,626	207,438,850
Mark VI (average)	23,180	8,180	28,257	231,142,260
Continental (average)	22,262	7,262	13,691	99,424,042
Total			101,574	538,005,152
Total domestic			507,730	1,642,096,533
FOREIGN				
Alfa Romeo: Spider and coupe	16,745	1,745	3,002	5,238,490
Audi:				
5000 4-door turbo automatic	19,425	4,425	1,933	8,553,525
5000 4-door turbo diesel	17,780	2,780	5,183	14,408,740
Quattro	35,000	20,000	240	4,800,000
Total			7,356	27,762,265
BMW:				
318 i	16,430	1,430	24,903	35,611,290
528 e	23,985	8,985	11,239	100,982,410
533 i	28,985	13,985	4,765	66,638,525
633 csi	39,210	24,210	2,611	63,212,310
733 i	34,300	19,300	6,003	115,857,900
Total			49,521	382,302,435
Nissan: 280ZX (average)	17,332	2,332	71,144	165,907,800
Peugeot:				
505 sedan STI—manual	15,215	215	1,812	389,580
505 sedan STI—automatic	15,215	585	3,921	2,293,785
505 sedan STD—manual	16,360	1,360	848	1,153,280
505 sedan STD—automatic	16,730	1,730	1,722	2,979,060
604 sedan TD—manual	19,780	4,780	332	1,586,960
604—automatic	20,534	5,534	332	1,837,288
Total			8,967	10,239,953

1983 COMPARISON—DOMESTIC AND FOREIGN—Continued

Manufacturer/model	Price	Price minus $15,000	Sales	Excess tax basis
Porsche:				
944 (average)	19,228	4,228	12,877	54,443,956
911 SC (average)	30,700	15,700	5,351	84,010,700
928 coupe	43,000	28,000	2,517	70,476,000
Total			20,745	208,930,656
Saab: 900 series (average)	16,895	1,895	12,117	22,961,715
Toyota:				
Celica Supra—automatic	15,998	998	6,300	6,287,400
Supra 2-door—manual	15,398	398	14,100	5,611,800
Total			20,400	11,899,200
Volvo:				
GL series (average)	15,534	534	20,914	11,168,076
Turbo 2-door	16,245	1,245	2,397	2,984,265
Turbo 4-door	16,555	1,555	6,818	10,601,990
Turbo Wagon	17,055	2,055D3,978	8,174,790	
760 series	19,300	4,300	8,730	37,539,000
760 GLE	20,330	5,330	2,223	11,848,590
Total			45,060	82,316,711
Mercedes-Benz:				
190 D	23,220	8,220	1,551	12,749,220
190 E	23,140	8,140	2,629	21,400,060
240 D	23,135	8,135	9,728	79,137,280
300 D	30,973	15,973	19,191	306,537,840
300 CD	34,193	19,193	2,002	38,424,386
300 TD	34,293	19,293	2,811	54,232,623
300 SD	37,970	22,970	18,759	430,894,230
380 SEL	47,870	32,870	4,879	160,372,730
380 SL	43,030	28,030	9,225	259,417,650
380 SEC	53,570	38,570	1,957	75,481,490
380 SE	42,730	27,730	928	25,733,440
Total			73,690	1,464,380,949
Jaguar:				
XJ6 (average)	32,000	17,000	13,183	224,111,000
XJS	34,000	19,000	2,632	50,008,000
Total			15,815	274,119,000
DeLorean	25,000	10,000	100	1,000,000
Ferrari	60,000	45,000	549	24,705,000
Rolls-Royce	100,000	85,000	1,046	88,910,000
Total foreign (including Mercedes-Benz)			329,512	2,770,674,174
Total domestic and foreign			837,242	4,412,770,707

Sources: Selected manufacturers/importers, automotive invoice service, Branham Automotive Service Book, NADA, Ward's Automotive Reports.

Mr. **Stark**. The record will be open for a while, and if you want to submit additional comments, we will be glad to make them part of the record.

Mr. **Blake**. Mr. Chairman, before we close, could I make a couple of comments? I am not here to try and sell Mercedes-Benz cars, but there is a reason why people pay $40,000 to $50,000 for a Mercedes, and $30,000 to $40,000 for an Avanti over, say, your $15,000 Ford

LTD or Chevrolet Caprice. Our cars last a lot longer. I do not know the exact age. You probably know better than I.

I have to admit that I had owned quite a few Mercedes, before becoming an auto manufacturer. Our owners keep our cars 3 to 5 years; that is probably 50 to 100 percent longer than the average American car. We feel that we build the best car in America, and I am sure Mercedes feels they build the best luxury car in the world, if not Germany. People spend that money because they are buying a car that does take a lot longer to build.

I am somewhat aware of the time it takes to build a Mercedes, and I am very much aware of the time it takes to build an Avanti. I have to go on record as saying that your statement that the UAW maintains that it takes just as long to build a $15,000 car as it does to build a $25,000 car is, I believe, based on incorrect information. I am sure we could get you exact data, but that is incorrect. The range in Detroit, in fact, is probably as much as 50 percent—it is much higher. The time to build a Mercedes, I understand, is much longer than an Avanti.

Mr. **Stark**. I can tell you if the UAW organizes in Stuttgart, you may get me off this bill, too.

Mr. **Blake**. People are paying more because our cars last longer. I do not think they should be penalized for that. I know the percentage of our cars that are used for business; they are kept a long period of time. Our average owner in what we call our "business arena" puts 20,000 plus miles a year on the car. We have a very high depreciation residual, as does Mercedes. People would not be spending what they spend on a Mercedes or an Avanti if it did not have that residual.

So I think we have to take that into consideration. Also, I do believe as my colleagues have said, that it is discriminatory. Just thinking aloud at some of the things they have said: Why should someone buy a very expensive CNC press that is built in Lorain, Ohio, when they can buy one in Japan for half-price? They are getting some tax benefit by buying it here in America.

I think that it is a luxury item. So are desks and furniture and things of that nature that you discussed this morning. I would think that they would have to be included. I think that if the level were raised, then it would be discriminatory under GATT.

I do not know the answer, but I think that before a decision on this bill can be made, we all need a lot more time to get the information together and gather it intelligently to make a presentation to you.

Thank you.

Mr. **Stark**. Thank you very much.

There being no other witnesses, the committee will stand adjourned subject to call of the Chair.

[Whereupon, at 5:10 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of the American Gas Association

INTRODUCTION

The American Gas Association (A.G.A.) is a national trade association comprised of nearly 300 natural gas distribution and transmission companies serving over 160 million customers in all 50 states. A.G.A. member companies account for approximately 85 percent of the annual natural gas utility sales in our nation.

Natural gas serves over half of both residential and commercial establishments in the U.S. and more of American industry than any other single fuel. Further, gas provides a secure source of energy because foreign developments do not disrupt our domestic supply. Greater recovery through varied nontraditional supply projects and improved technology will increase supply security for customers and permit further progress toward assuring gas-using companies of the supply stability on which long-term business decisions often depend.

The A.G.A. is concerned that some of the measures proposed by the Administration will adversely affect the natural gas industry. We therefore appreciate this opportunity to present our views on this important subject.

Premature accrual (time value of money)

The Administration has proposed postponement of allowable deductions under the "all events" test (except where specifically allowed by status), where economic performance will occur more than one year after the end of a taxable year. Under the proposal, the net operating loss (NOL) carryback rules would also be amended "for certain types of liabilities" to allow losses to be carried back more than three prior taxable years.

The Association respectfully urges the Committee not to adopt this proposal. The cash and accrual methods have been worked out in litigation over long periods of time. This proposal is contrary to generally accepted accounting principles and the convention of accrual accounting principles and the convention of accrual accounting. If this proposal were adopted, complying taxpayers would be required to maintain separate book-tax records and to track the variance between the two. This would increase the taxpayer's cost of doing business. While some provisions of current law may create timing differences favorable to a particular taxpayer, on balance the rules as a whole are perceived as fair to the taxpayer and to the government. *Ad hoc* amendments, such as those proposed by the Administration, will destroy that balance and add unneeded complexity.

A.G.A. believes that current law should be preserved. Accrual basis taxpayers are now permitted to take deductions when all the events have occurred establishing the fact of liability and an amount can be determined with reasonably accuracy. At such time, the amount of the liability, in real dollars, is a true cost of doing business and should be deductible in full. Deferral of deductions to later periods mismatches revenues and expenses and artificially accelerates taxable income. For rate-regulated enterprises, such as utilities, it also creates the potential for the inequitable sharing of costs between their current and future consumers/ratepayers, since the proposal postpones the recognition of a significant cost of doing business to a future period. Under this proposal, current customers of the utility, who would be the recipients of the benefits of the energy supplies, would benefit at the expense of future customers who would be forced to pay for the removal of reclamation of energy projects with no concomitant increase in supply.

Postponing the time for deduction may even result in the loss of the deduction. The Administration proposal is not clear as to either the kinds of liabilities which would be eligible for a longer than three-year NOL carryback or the length of carryback which would be permitted for the eligible liabilities. Various alternatives could be enacted, including (1) extending the additional years of carryback beyond the existing carryback/carryforward rules, (2) a one-year carryback to the "obligation year" for unused postponed deductions, or (3) the application of the existing loss carryback/carryforward rules from the "obligation year" to any unused postponed deductions, or (4) the application of the existing loss carryback/carryforward rules from the "obligation year" to any unused postponed deduction. In any case, insufficient taxable income may exist in such years to permit full utilization of any postponed deduction. This is particularly true of energy projects such as platform removal, where the project may have been "winding down" in recent years and thus not have generated sufficient recent income to offset the deduction. Additionally, deductions ordinarily proper under the "all events" test could not be carried back or forward from the "obligation year" to ensure full utilization. In such cases, the proposal would effectively eliminate the deduction for properly incurred business costs.

The effect on taxpayers in extractive industries which are of great concern to the Association, would be particularly burdensome. Because removal and reclamation costs tend to inflate over time, ultimate costs and lost deductions under the proposed carryback amendment will be higher for such taxpayers. This will eventually result in diminished supplies of needed domestic and natural gas to run factories and heat homes, since extractive companies will tend to avoid significant investments in frontier type projects whose reclamation costs may be higher.

A.G.A. believes that business costs should deductible when liability for those costs is established by law or contract. This rule should be evenly applied to all taxpayers, including taxpayers in extractive industries. Accordingly, if any modification of existing law is necessary, such modification should instead clarify that all taxpayers may deduct their obligations when the amounts of such obligations are reasonably determinable. The existing proposal not only is inappropriate from an accounting standpoint; it also will either penalize taxpayers who incur long-term obligations or discourage their doing so. In addition, it is unneeded, since adequate remedies already exist under current law to combat abuses.

Dividends—leveraged stock investments

A.G.A. opposes this proposal absent a statutory clarification exempting borrowings used in connection with the purchase of stock for merger and other acquistition-related activities that are distinguishable from portfolio-investments. We also believe that this provision should be considered as part of ongoing Subchapter C revisions rather than one a piecemeal basis.

The language of this proposal as introduced is too broad and could deterimentally affect bona fide merger and acquisition activity involving the use of borrowed funds. We recommend that the statutory language limit the type of investment for which borrowed funds may not be used without losing the eighty-five percent dividends-received deduction to situations where the taxpayer borrows money to invest in "portfolio-type securities." It also should specify at what point the eighty-percent ownership requirements need to be achieved vis-a-vis the borrowing activity. In particular, the impact of this rule upon open-ended borrowing arrangements needs to be assessed. We also recommend that the restriction upon the dividends-received deduction be limited to those situations where a taxpayer borrows to invest in "portfolio-type securities," as provided in a statutory definition.

CONCLUSION

The American Gas Association appreciates the opportunity to present its views on the above issues to the Committee. We strongly urge the Committee to consider and adopt our suggestions for amendment.

American Petroleum Institute,
Washington, D.C., February 29, 1984.

Mr. John J. Salmon,
Chief Counsel, Committee on Ways and Means,
House of Representatives, Washington, D.C.

Dear Mr. Salmon: In response to the announcement of hearings made by Chairman Rostenkowski on February 1, 1984, the American Petroleum Institute (hereinafter the "API") respectfully submits the following comments with respect to certain of the partnership "tax-shelter" related proposals which are included in the President's fiscal year 1985 budget and which are the subject of hearings by the Committee on Ways and Means. The comments concerning the administration's partnership proposals are based upon the General Explanations set forth in the document entitled "Revenue Proposals Contained in the Administration's Fiscal Year 1984 Budget" issued by the Department of the Treasury on February 17, 1984. Reference also was made to the document entitled "Proposals Relating to Tax Shelters and Other Tax-Motivated Transactions" prepared by the Staff of the Joint Committee on Taxation.

The Administration's partnership proposals are of concern to the oil and gas industry, not because the industry structures its partnership transactions to seek the benefits which the proposals would limit, but because the industry is concerned that the proposals might have an unwarranted and broader impact than the curbing of "tax-shelter" abuses. The API agrees with Chairman Rostenkowski's statement that "[t]o the extent that abuses can be curtailed without unduly interfering with ordinary business transactions, Congress should act to reform the law." (Committee on Ways and Means, Press Release #19, February 1, 1984.) The oil and gas industry is concerned, however, that these proposals could interfere with ordinary oil and gas industry partnerships which cannot be characterized as "tax shelters" under any reasonable definition of that term. In their present form, the proposals lack the focus that is necessary in order to avoid affecting typical oil industry transactions which are not the intended targets according to Chairman Rostenkowski. Without such focus, the Administration's proposals could unnecessarily increase complexity, become a trap for the unwary, and cause administrative problems for both taxpayers and the Internal Revenue Service.

The proposal to make mandatory the application of section 704(c)(2) illustrates the potential overreach of the proposals and is of particular concern to the oil and gas industry. The stated purpose of this proposal is to prohibit the shifting of unrealized precontribution benefits and burdens in the form of depreciation, depletion, and gain or loss from contributing partners to other partners. The example given in the Administration's proposal, however, pertains only to the potential shifting of unrealized precontribution gains or losses when a sale occurs by the partnership after contribution.

The insignificant revenue impact of this proposal as estimated by Treasury raises a question as to whether the frequency of these situations warrants mandatory section 704(c)(2) allocations pertaining to unrealized precontribution gains or losses for all types of business ventures, especially those typically entered into by oil and gas industry concerns. In the case of the usual oil and gas partnership, the contributed property is not sold, but rather produced, and the material consideration is not gain or loss from sale, but depreciation and depletable basis (*See* section 613A(c)(7)(D)). Even in those situations when mandatory section 704(c)(2) allocations for gains or losses may be appropriate, it is unclear what consideration, if any, has been given to mandatory allocations of depreciation or depletion under section 704(c)(2).

A review of the Administration's proposal and the above cited Joint Committee print fails to identify how section 704(c)(2) allocations of depreciation and depletion would further the Administration's objectives. The question is further confused by references to mandatory depreciation and depletion allocations under section 704(c) contained in the June, 1983 testimony of Mr. Robert S. Woodward before the Subcommittee on Oversight of the Internal Revenue Service, Senate Committee on Finance. The cited testimony appears to mean that depreciation and depletion under the mandatory section 704(c)(2) proposal would be allocated to the property contributing partner(s). If this is intended, the result would be similar to allocations of depreciation and depletion in typical oil industry joint venture arrangements where these attributions are allocated to the partner(s) contributing property to the venture in accordance with the relative economic benefits and burdens borne by such partner(s). However, under section 704(c)(2), depreciation (or depletable basis under section 613(c)(7)(D)) could be allocated in disproportionally greater amounts (and in some cases totally allocated) to the noncontributing partner(s). Not only is this inconsistent with the economic benefits and burdens actually borne by the partners in oil industry joint venture arrangements, the mandatory allocation of depreciation and depletable basis under section 704(c)(2) seemingly does not further the stated objectives of the Administration. Before section 704(c)(2) is made mandatory in its present form, further consideration should be given to this inconsistency between the result in the case of gain or loss from sale and the case of depreciation and depletion.

If the perceived abuse which is intended to be addressed is a shifting of gain or loss where there is a preconceived intent to sell the property after contribution, then the proposal should not be made generally applicable to all contributions of property. Consideration should be given to clarifying the proposal to render it inapplicable to oil and gas property contributions to partnerships where the purpose of the contribution is to facilitate the drilling of a well, not the sale of the contributed property. In the majority of the contributions of undeveloped oil and gas properties to partnerships, there is no preconceived intent to sell the property after contribution. In any event, precontribution changes in value are irrelevant to the parties whose purpose is to establish the existence of producible oil and gas reserves by a discovery well. Such precontribution changes in value are usually insignificant compared to the value, or lack thereof, that results from the drilling of a well.

Another serious concern raised by the proposal is the valuation of oil and gas properties, particularly unexplored oil and gas properties. If mandatory allocations with respect to contributed depletable properties are required, then valuation of properties at time of contribution would be required. This would be a significant change in the manner in which the industry handles its partnerships. Currently, in situations where one party contributes an oil and gas lease to a partnership and a second party contributes the funds to drill a well on such lease, no attempt is made to determine the fair market value of the lease being contributed. In the example in the Administration's proposals it is presumed that the value of the contributed property is determined by the amount of cash contributed. While this assumption is no doubt appropriate in some business arrangements, such an assumption is not appropriate in the oil and gas industry. In the oil and gas situations set forth above equating the drilling costs with the fair market value of the contributed leasehold overlooks both the inherent risk associated with the venture and the essence of the venture as perceived by the parties. The drilling party is interested in exploring the contributed property in the hope of finding oil and gas reserves. Accordingly, he is willing to bear the costs of drilling a well to determine if such reserves exist, but the willingness to bear such costs has little relationship to the value of the contributed property. It is only after this well is drilled that the real value of the lease to the parties may become known.

While it is possible to value the leases at the time of contribution, such value would be largely irrelevant to the parties, as well as highly speculative and controversial. Regardless of the value determined, the oil and gas property generally would not be sold by the venture prior to the time the well was drilled. Moreover, in contrast to a real estate transaction where it is reasonably certain that the expenditure of funds on the contributed property will increase its value, there is no such certainty in the oil and gas business. The value of such property could increase or decrease dramatically depending on the results from the drilling of the well. It is only after the well has been drilled that the property would ever be sold and, even then, it is unlikely that the partnership would sell the property. It is more likely that the partnership would, if oil reserves were discovered, develop and produce the property or, if no oil reserves were discovered, terminate the partnership and distribute to the parties their respective interests in the leasehold. Any subsequent sales by the parties would reflect the appropriate gain or loss to be recognized by each of the parties.

In conclusion, while we agree with the stated objectives of eliminating abuse situations, the breadth of the proposals, particulary with regard to section 704(c)(2), would have serious potential for harming normal business arrangements in the oil and gas industry. Accordingly, the API urges that every effort be made to narrow the proposals so as to affect only targeted tax shelter arrangements. If the Administration's partnership proposals cannot be effectively narrowed to avoid unintended adverse effects on legitimate business transactions, unnecessary complexity, and attendant administrative problems, the proposed legislation should be deferred pending further consideration.

Very truly yours,

CHARLES J. DIBONA, *President.*

STATEMENT OF R. WILLIAM TAYLOR, PRESIDENT OF THE AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES

The American Society of Association Executives (ASAE) is headquartered in Washington, D.C. and is the single largest umbrella association for the vast majority of national, regional and state trade associations and professional societies in the United States. Many of ASAE's member trade associations sponsor voluntary employees' beneficiary associations (VEBAs) for their members and their employees. Typically, these trade association-sponsored VEBAs provide life, health, accident and other similar benefits to the employer members and their employees on either an insured (unfunded) or self-insured (funded) basis. Many of these employer members can be classified as small businesses.

The Joint Committee on Taxation has made certain proposals regarding (1) the amount and timing of deductions for employer contributions to VEBAs and (2) the tax treatment of VEBAs. Joint Committee on Taxation, "Proposals Relating to Tax Shelters and Other Tax-Motivated Transactions," JCS-5-84 (February 17, 1984). Since many of ASAE's member trade associations sponsor VEBAs, ASAE has reviewed these proposals with great interest and has considered whether or not any additional proposals regarding VEBAs should be brought to the attention of this Committee.

It is apparent to ASAE that the Joint Committee's proposals are intended to curb certain recent and novel abuses in the use of VEBAs and are not intended to adversely affect the traditional, nonabusive VEBAs which are sponsored by ASAE's members. ASAE is in accord with the Joint Committee's intent and would hope that a like intent be clearly reflected in any legislation affecting VEBAs which this Committee recommends to the House of Representatives.

ASAE has reviewed the Joint Committee's proposals regarding VEBAs and has concluded that these proposals might have certain unintended effects which would create technical and other problems for the traditional VEBAs sponsored by ASAE's members. In particular, the Joint Committee's proposals might very well operate to exclude many small businesses from participation in trade association-sponsored

VEBAs. ASAE would urge this Committee, as it considers legislative proposals designed to curb abuses in the use of VEBAs, not to create rules which would place special burdens on certain classes of business, such as small businesses. For example, the proposal which would limit benefits provided under a VEBA to officers, owners and highly compensated employees to 25 percent of all benefits paid annually would appear to preclude many small businesses from participating in VEBAs.

In addition, ASAE also has concluded that there is at least one additional proposal regarding VEBAs which merits the consideration of this Committee. This additional proposal is the direct result of the Internal Revenue Service's overly restrictive interpretation and administration of section 501(c)(9) of the Internal Revenue Code, which creates the tax exempt status of VEBAs. Before discussing this additional proposal, it will be necessary to briefly review the statutory and administrative history of section 501(c)(9).

The predecessor to section 501(c)(9) first appeared in the Revenue Act of 1928, 45 Stat. 812. The relevant portions of that Act read as follows:

"SEC. 103. EXEMPTIONS FROM TAX ON CORPORATIONS.

"The following organizations shall be exempt from taxation under this title—

> "(16) Voluntary employees' beneficiary association providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents, if (A) no part of their earnings inures (other than through such payments) to the benefit of any private shareholder or individual, and (B) 85 per centum or more of the income consists of amounts collected from members for the sole purpose of making such payments and meeting expenses. . . ."

There appears to have been no debate on the floor of the House or the Senate concerning this provision, nor any testimony in support of or in opposition to it at hearings before the Ways and Means or Senate Finance Committees. The reports on the Act issued by the House Ways and Means and Senate Finance Committees do little to illuminate the reasons for the enactment of the provision. The relevant portion of the Senate Finance Committee Report is illustrative and states as follows:

"Voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to members and their dependents are common today, and it appears desirable to provide specifically for their exemption from the ordinary corporation tax. Consequently, the House Bill provides in section 103(15) (section 103(16) of the Act) that such associations shall be exempt if they provide for the payment of life, sick, accident, or other benefits to members of the association or their dependents, and if no part of their net earnings inures to the benefit of any private shareholder or individual and if 85 per cent or more of the net income is collected from the members for the purpose of paying expenses and meeting losses. A clarifying amendment is made in this paragraph relating to voluntary employees' beneficiary associations, which does not, however, change the purpose of the House Bill. Senate Finance Committee Report (70th Cong., 1st Sess., S. Rept. 960)."

Between 1928 and 1969, no significant changes were made in the statute, and no regulations or proposed regulations were published by the Treasury Department. A number of published and private rulings interpreting section 501(c)(9) were issued by the IRS, and none of them indicated that any restrictions were placed upon VEBAs established by employer groups, such as trade associations, which were not imposed upon other groups.

In 1969, the IRS published proposed regulations which provided that in order to be exempt from tax under section 501(c)(9), an organization must be an "association of employees". The term "association of employees" was defined by the proposed regulations, in part, as follows:

"An organization described in section 510(c)(9) must be composed of individuals who are entitled to participate in the association by reason of their status as employees who are members of a common working unit. The members of a common working unit include, for example, the employees of a single employer, *the employees of one industry,* or the members of one labor union. Proposed reg. § 1.501(c)(9)-1(b)(1)(i) (January 23, 1969." (Emphasis added.)

Pending the adoption of the proposed regulations, organizations otherwise meeting the requirements of section 501(c)(9) and sponsored by trade associations representing employers of one industry were routinely granted tax exempt status under section 501(c)(9). Tax exempt status was granted to numerous trade association-sponsored associations, usually in the form of employees trust, at the national, state and local levels.

The 1969 proposed regulations were never adopted, in large part due to union opposition to provisions in the regulations which are not relevant to trade associations. Instead, the Treasury Department issued new proposed regulations on August

17, 1980. For the first time, the 1980 proposed regulations introduced the concept of the employment-related common bond. Finally adopted on January 7, 1981 (effective January 1, 1981), the regulations provided, in relevant part, as follows:

"Section 1.501(c)(9)-2 *Membership in a Voluntary Employees Beneficiary Association: Employees; Voluntary Association of Employees.*

"(a) *Membership*—(1) In general the membership of an organization described in section 501(c)(9) must consist of individuals who become entitled to participate by reason of their being employees and whose eligibility for membership is defined by reference to objective standards that constitute an employment-related common bond among such individuals. Specifically, those eligible for membership in an organization described in section 501(c)(9) are defined by reference to a common employer (or affiliated employers), to coverage under one or more collective bargaining agreements (with respect to benefits provided by reason of such agreements(s)), to membership in a labor union, or to membership in one or more locals of a national or international labor union. For example, membership in an association might be open to all employees of a particular employer, or to employees in specified job classifications working for certain employers at specified locations and who are entitled to benefits by reason of one or more collective bargaining agreements. *In addition, employees of one or more employers engaged in the same line of business in the same geographic locale will be considered to share an employment-related bond for purposes of an organization through which their employers provide benefits* . . . Whether a group of individuals is defined by reference to a permissible standard or standards is a question to be determined with regard to all the facts and circumstances, taking into account the guidelines set forth in this paragraph. Reg. §1.501(c)9)-2." (Emphasis added.)

Though the concept of "geographic locale" was ostensibly included in the regulations merely as an example of the type of employment bond which would be deemed to satisfy the requirement of the regulation, ASAE and other groups opposed the language in testimony delivered to the IRS in connection with its consideration of the proposed regulation. Despite unanimously unfavorable testimony, which reflected fears of taxpayers that the geographic locale language would be interpreted as mandatory rather than as an example, the IRS adopted this portion of the regulation as proposed.

The preamble to the regulations explained the reason for the geographic locale requirement as follows:

"MEMBERSHIP

"Several comments requested deletion of the provision that restricts membership in voluntary employees' beneficiary associations in the multiple employer context (so-called "multi-employer trusts") to those engaged in the same line of business in the same geographic locale. This provision is retained. First, section 501(c)(9) provides for the exemption of associations of employees who enjoy some enjoyment related bond. Allowing section 501(c)(9) to be used as a tax-exempt vehicle for offering insurance products to unrelated individuals scattered throughout the county would undermine those provisions of the Internal Revenue Code that prescribe the income tax treatment of insurance companies. Second, it is the position of the Internal Revenue Service that where an organization such as a national trade association or business league exempt from taxation under section 501(c)(6) operates a group insurance program for its members, the organization is engaged in an unrelated trade or business. *See* Rev. Rul. 66-151, 1966-1 C.B. 151; Rev. Rul. 73-386, 1973-2 C.B. 191; Rev. Rul. 78-52, 1978-1, C.B. 166. To allow trade associations to provide insurance benefits through a trust exempt under section 501(c)(9) would simply facilitate circumvention of the unrelated trade or business income tax otherwise applicable to such organizations. Federal Register, Vol. 46, p. 1720 (January 7, 1981)."

Subsequent to the issuance of the final regulations the IRS issued a number of private rulings and denials of applications for tax exempt status filed by trade association-sponsored employee beneficiary associations organized on state, multistate or national levels. Though the preamble to the regulations referred only to "national trade associations", the policy of the IRS quickly extended the restriction to organizations organized and operated on a statewide or larger basis. An Internal Revenue Manual provision published on November 9, 1981, contained the following directions to IRS agents in the field:

"MULTIPLE EMPLOYER TRUSTS

"Employees of one or more employers engaged in the same line of business in the same geographic locale share an employment related common bond. However, the geographic locale limitation effectively denies exemption to national or statewide multiple employer trusts, unless they are established pursuant to a collective bargaining agreement. This provision is intended to prevent IRC 501(c)(9) from being used as a tax exempt vehicle for offering insurance products to unrelated individuals scattered throughout the country which would then undermine those provisions of the IRC concerning insurance companies. In addition, where an organization such as a national trade association or business league exempt under IRC 501(c)(6) operates a group insurance program for its members, the organization is engaged in unrelated trade or business. To allow trade associations to provide insurance products through an IRC 501(c)(9) organization would facilitate circumvention of the unrelated trade or business income tax otherwise applicable to this situation. Prior to the publication of the final regulations, some multiple employer trusts formed by trade associations received favorable rulings. However, under the final regulations, multiple employer trusts, whether formed by trade associations or insurance companies, will not qualify for exemption under IRC 501(c)(9) unless they qualify under the geographic locale limitation. (See section 1.501(c)(9)-8 of the regulations for the effective date of these provisions). Internal Revenue Manual, Sec. 932, p. 7751-149 (November 9, 1981)."

In mid-1983, ASAE established a task force whose goal is to achieve reversal of the geographic locale restriction. The task force met with representatives of the Treasury Department, White House, OMB and IRS. Memoranda were prepared and circulated by the Treasury Department and the other agencies. The OMB and the White House staff were sympathetic and offered assistance. In December, 1982, it was learned that the Chief Counsel of the IRS had recommended in a memorandum to the technical staff that organizations organized and operated on a statewide or smaller basis could be considered eligible for section 501(c)(9) status if they met the other requirements imposed by the regulations, but that multi-state and national VEBAs would continue to be ineligible for tax exemption under section 501(c)(9).

The reasons for ASAE's opposition to the IRS's geographic locale requirement are simple. There simply is no support whatsoever for this requirement in section 501(c)(9) or its predecessors or in the very sparse legislative history of section 501(c)(9). Furthermore, this requirement is directly contrary to the salutary purpose of section 501(c)(9) to provide a tax-exempt vehicle for the provision of necessary benefits at a reduced cost to employees. Finally, the regulations under section 501(c)(9) grant tax exempt status to a VEBA sponsored by a single employer operating in two or more states and to a VEBA sponsored by a regional or national labor union. Yet these same regulations unjustifiably discriminate against a VEBA sponsored by a multi-state or national association of employers by denying tax exemption to such VEBA.

For all of the above reasons, ASAE requests this Committee to favorably consider a proposal to amend section 501(c)(9) to allow tax exemptions to any VEBA which meets all the requirements of section 501(c)(9) without regard to the geographic scope or coverage of the VEBA. In making this proposal, ASAE urges the Committee to consider that any legislation which it may adopt regarding VEBAs should not only curb the recent aberrant abuses in the use of VEBAs, but should also ensure that traditional non-abuse VEBAs should be free to operate without any unnecessary restrictions unrelated to the purpose and requirements of section 501(c)(9). In this regard it should be remembered that VEBAs, in providing valuable and necessary benefits to the workers of America, contribute in a very significant way to reducing the burdens on government.

ASAE would like to express its gratitude to the Committee for the opportunity to submit this written statement.

AMERICUS SHAREOWNER SERVICE CORP.,
New York, N.Y., March 1, 1984.

JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means,
Longworth House Office Building, Washington, D.C.

DEAR MR. SALMON: The staff of the Joint Committee on Taxation on February 17, 1984 released a pamphlet outlining a series of proposals for limitations on what the pamphlet describes as "tax-motivated transactions". Five of these proposals are aimed at the dividends received deduction allowed by Section 243 of the Code, the allowance of which deduction is described by the pamphlet as a "preferential tax treatment". One of these proposals would directly and adversely impact the business of Americus Shareowner Service Corporation ("Americus"). That proposal relates to "multiple-class grantor trusts" and (i) would disallow the dividends received deduction for "a shareholder that does not have all the incidents of ownership with respect to stock" or (ii) would, as an alternative, treat "multiple class grantor trusts as associations taxable as corporations". Americus is the sponsor of one existing trust, components of which are listed on the New York Stock Exchange and is also the sponsor of a number of "multiple-class grantor trusts" now in registration with the Securities and Exchange Commission. The proposal appears to be directly aimed at these trusts.

The staff description of the trusts which we sponsor is mistaken and it is, we believe, this error that has led the staff to include the proposal aimed at the trusts we sponsor among its proposals for additional "limitations" on "tax motivated transcations". Under our trusts, the holders of prime components do not merely expect to "recover the cost of their interests". They also share in the appreciation of each share of underlying stock represented by their prime components up to the amount stated in the indenture *which always exceeds the entire value of a share of underlying stock* at the time the initial exchange with the trust is made. (A $75.00 limit applies to the existing trust whereas the entire value of an underlying share of stock at the time of the initial exchange was about $65.00). The arrangement is thus not a device for separating a dividend right from a capital right since the prime component includes both the right to dividends and a limited right to appreciation (up to about 15% over the value of an entire share of underlying stock when the existing trust was established). The economic motivation for the purchase or sale of a prime or score component is clear and depends upon the varying estimates of score component and prime component holders as to the future trend of distributions on and prices of the underlying stock. The 5 year life of the trust and the fact that the prime holder's downside risk is unlimited assures that the purchaser of a prime component has made a true investment and has not merely entered into a tax motivated transaction to pick up the dividends received deduction without assuming ownership risks.

The score components in the multiple-class grantor trusts we sponsor (which have a life on the order of 5 years) are not "the economic equivalent of call options to purchase the underlying stock" as stated in the staff pamphlet, because (1) the score component owner can never receive the share of its underlying stock to which the score component relates or all of its appreciation since the initial exchange, because the prime component holder has the right to all appreciation from the original exchange date up to the stated dollar limit and (2) no purchase payment is involved, the score component being an ownership interest. The underlying point here is illustrated by Rev. Rul. 80-238, 1980-2 Cum. Bull., 96 (copy enclosed) which holds that even where a call option was in fact granted by a corporate holder of stock, the dividends received deduction was allowable where the option was not "in the money" at the grant date, *i.e.*, where some possibility of appreciation was retained by the writer of the call.

To state our position more broadly, the dividends received deduction "provided in section [243] of the Internal Revenue Code is based upon the theory that a corporate tax has already been paid upon the earnings out of which the dividends are distributed". Rev. Rul. 104, 1953-1 Cum. Bull. 68. We see nothing in the multiple-class grantor trust situation which detracts from the accomplishment of that purpose.

The alternative proposal, *i.e.* to treat a multiple-class grantor trusts as an association taxable as a corporation, is a clear case of (i) overkill in that it would adversely affect non-corporate holders of prime components by imposing the inter/corporate dividend tax at the trust level and (ii) underkill with respect to the intended objective, because a corporate holder of prime units would suffer only a 13.32 percent tax attrition of dividends (6.9 percent at the trust level plus 6.42 percent (6.9 percent x (100 percent—6.9 percent)), at the unit holder level.

The staff proposal to attack multiple-class grantor trusts as tax-motivated transactions for the reasons stated is particularly ironic because, (1) the multiple-class grantor trust achieves the direct pass-through of dividend character which the staff apparently thinks desirable, in view of the fact that the staff also proposes to increase from 75 percent to 90 percent the dividend component of a regulated investment company's income required before distributions by the regulated investment company are treated as dividends in their entirety and (2) the Treasury, in its General and Technical Explanations released on the same date as the staff pamphlet advocates establishment of grantor trust (i.e. non-taxpayer) status for multiple-class trusts in investing in mortgages—the TIMs proposal.

On the basis of the foregoing, we submit that the staff proposals regarding "multiple-class grantor trusts" should be rejected.

If, for any reason, the tax treatment of multiple class grantor trusts is adversely changed, we further submit that in fairness to the holders of units in such trusts and in fairness to us, in view of our heavy investment in time and money in the creation of such trusts, any such changes should not apply to a trust which was (i) established and had units listed on a national stock exchange or (ii) was in registration with the Securities and Exchange Commission at the date of enactment.

Very truly yours,

A. JOSEPH DEBE, *President.*

percent dividends received corporate deduction under section 243 of the Code, subject to the limitations under 854, is correct; and whether unexercised option gains realized by a regulated investment company are excluded from gross income for purposes of section 854(b). See Rev. Rul. 80-345, page 204.

Section 246.—Rules Applying to Deductions for Dividends Received

26 CFR 1.246-3: Exclusion of certain dividends.
(Also Section 243; 1.243-1.)

Call option; dividends received deduction; holding period. The writing of a call option by a domestic corporation on stock held by the corporation does not reduce the holding period that is required by section 246(c)(1)(A) of the Code for purposes of the deduction for dividends received provided by section 243.

Rev. Rul. 80-238

ISSUE

Does the writing of a "call" option by a taxpayer on stock held by the taxpayer reduce the holding period required by section 246(c)(1)(A) of the Internal Revenue Code for purposes of the allowance of the deduction for dividends received provided by section 243 of the Code?

FACTS

The taxpayer, a domestic corporation engaged in an insurance business, purchases regularly traded common stock of other domestic corporations for investment purposes. In order to earn additional income, the taxpayer writes "call" options on such stock within 15 days of their purchase. The taxpayer receives immediate payment for these options and, in return, provides buyers with the right, for a specified period of time, to demand delivery of the underlying stock at a stated price. For example, the taxpayer purchased stock at $110 per share and sold call options on this stock at $10 per share that could be exercised within six months of purchase, with the striking price for the stock fixed at $130. At the time that the taxpayer wrote the options, the market price of the stock had risen from $110 to $120 per share.

LAW AND ANALYSIS

Section 243 of the Code allows a corporation a deduction for certain amounts received as dividends from a domestic corporation.

Section 246(c)(1)(A) provides that no deduction shall be allowed under section 243 in respect of any dividend on any share of stock that is sold or otherwise disposed of in any case in which the taxpayer has held such share for 15 days or less.

The flush language of section 246(c)(3) of the Code and the Income Tax Regulations thereunder provide that, for purposes of section 246(c)(1)(A), the taxpayer's holding period in stock shall be appropriately reduced (in the manner provided in the regulations) for any interval (during such period) in which the taxpayer has an option to sell, is under a contractual obligation to sell, or has made (and not closed) a short sale of substantially identical stock or securities.

Neither the Code nor the regulations specifically mentions call options. Therefore, it is necessary to determine whether the sale of such options is equivalent to any of the transactions listed in flush language.

The sale of a call option does not create in the seller an option to sell the underlying stock since consummation of the stock sale is under control of the person to whom the call was sold. *See* Rev. Rul. 58-234, 1958-1 C.B. 279. Furthermore, the sale of a call option is not a short sale since it is the sale of the right to acquire stock rather than the sale of the stock itself. *See Provost v. United States*, 269 U.S. 443 (1925), T.D. 3811, V-1 C.B. 417 (1926). Finally, although the writing of a call option on stock owned could be deemed to be a contractual obligation to sell, the legislative history of section 246(c) indicates that, for purposes of section 246(c)(3), it is not.

The flush language of section 246(c)(3) was enacted to reduce a taxpayer's holding period for any interval during which the taxpayer is in both a "long" and a "short" position. S. Rep. No. 1983, 85th Cong., 2nd Sess. 28-9 (1958), 1958-3 C.B. 922, 949-50. This insures that the taxpayer is at the risk of the market for the entire holding period. *See* section 1.246-3(d)(2) of the Income Tax Regulations.

The writing of call options on stock owned affords the writer no protection against loss, beyond the option price received, in the event the underlying stock declines in value. Therefore, since the writing of these options does not place the writer in a risk-free position, it does not come within the intendment of the statute. Such considerations, however, are not applicable to "in-the-money" call options, that is, call options that are sold with a striking price below the market price of the underlying stock on the date that the option is written, since in such a situation the exercise of such options may be virtually guaranteed and the element of risk is either greatly reduced or eliminated.

HOLDING

The writing of a call option by a taxpayer on stock held by the taxpayer does not reduce the holding period required by section 246(c)(1)(A) of the Code for purposes of the allowance of the deduction for dividends received provided by section 243.

Part IX.—Items Not Deductible

Section 262.—Personal, Living, and Family Expenses

26 CFR 1.262-1: Personal, living and family expenses.

Deductibility of an airline pilot's expenditures on tuition and fees for an aviation program, where the expenses are directly

STATEMENT OF EDWIN E. CAIN, VICE PRESIDENT FOR GOVERNMENT RELATIONS, APACHE CORP.

My name is Edwin E. Cain. I am Vice President for Government Relations of Apache Corporation ("Apache"), a New York Stock Exchange listed corporation that is the sole general partner of Apache Petroleum Company ("APC"), on whose behalf I submit this statement in opposition to the proposal recently noted by the Joint Committee Staff to tax publicly traded partnerships as associations taxable as corporation. I understand that the Staff has noted other proposals to tax certain large non-traded partnerships as corporations; although I am equally opposed to these proposals, I limit this statement to the proposal affecting publicly traded partnerships.

APC is a publicly traded, New York Stock Exchange listed limited partnership engaged in the exploration, development and production of oil and natural gas in the continental United States. Since 1959, Apache has also served as sponsor and managing general partner of 64 publicly registered partnerships involving 30,000 investor/partners. These partnerships have raised over $700 million for oil and gas exploration and production. I oppose any measure to treat publicly traded partnerships as corporations for tax purposes. Such a step would frustrate long-standing Congressional policies that encourage capital investment in important industries that are vital to our nation's economic well-being. In addition, this step would be fundamentally inconsistent with existing tax policy.

To treat publicly traded limited partnerships as corporations would frustrate national economic policy by impeding the flow of capital into areas in which Congress has heretofore sought to encourage investment, such as energy exploration and development, housing construction, and research and experimentation. In his October 24, 1983 statement to the Senate Finance Committee concerning a staff proposal to treat publicly traded partnerships as corporations, Deputy Assistant Secretary for Tax Policy Ronald Pearlman demonstrated the Administration's recognition that a move to curtail the use of limited partnerships would produce undesirable economic results by cautioning that "[a]ny proposal that might reduce significantly the flow of capital into these ventures must be considered carefully."

There seems little doubt that treatment of publicly traded or large limited partnerships as corporations would significantly reduce that flow of capital. Congress has recognized that tax benefits must be provided in order to encourage investment in these areas. Limited partnerships have been the most efficient means of delivering these tax benefits to investors in exchange for their capital and, obviously, large limited partnerships are more efficient than small ones as vehicles for raising this capital.

The importance of limited partnerships in attracting capital to the oil and gas industry is illustrated by the following statistics. In 1981, 55 percent of all oil and gas securities offerings registered with the SEC (over $4 billion in dollar investment) were in limited partnership form. In 1982, that percentage had increased to 83 percent (over $6 billion) although the total dollar investment (between $7.2 and $7.3 billion) remained relatively static. These figures make clear that the amount of new capital invested in oil and gas exploration and development would have fallen dramatically had it not been for the availability of large limited partnerships as investment vehicles. The fact is that this investment—especially necessary now that domestic oil and gas reserves are falling, not rising—would not have occurred, and will not occur, if public investors had been, or are, required to buy corporate stock, the value of which generally trades at a substantial discount from underlying asset value. The plain fact is that the corporate structure is an ineffective vehicle for raising the capital to develop most of our domestic oil and gas reserves.

Publicly traded partnerships increase the effectiveness of limited partnerships as capital formation tools. The attractivenss of all limited partnership interests as investments is increased when the potential exists that they will be "rolled up" into a large publicly traded partnership, after exploration has substantially occurred and most reserves have been valued. At this time, the publicly traded partnership, offering a much smaller unit price than does the non-traded partnership, provides the small investor with increased investment safety and liquidity. Publicly traded partnerships thus make it possible for small investors as well as large investors to participate in the capital formation process. The fact that APC alone has raised over $80 million in investment capital demonstrates that publicly traded partnerships can play an effective role in raising capital for domestic energy development.

Legislation to treat publicly traded or large limited partnerships as corporations for tax purposes would be as inconsistent with our nation's tax policy as with our nation's economic policy. Under existing case law and regulations—which have been developed from factual criteria first enunciated by the Supreme Court fifty years ago—four characteristics are used to distinguish associations taxable as corporations from partnerships: limited liability, continuity of life, centralization of management and free transferability of interests. A limited partnership must have at least three of these characteristics to be treated as a corporation for tax purposes. A publicly traded partnership meets this test for partnership status and the IRS has so ruled on a number of occasions. Free transferability, by itself, simply does not turn a partnership into a corporation.

But the proposal to tax publicly traded partnerships as corporation does not even address the issue of free transferability. Partnership interests need not be publicly traded to be freely transferable; free transferability exists if limited partners have the power, without the consent of the other partners, to substitute others for themselves as partners. Thus, limited partnership interests in many, if not most, limited partnerships are freely transferable even though they are not publicly traded.

The proposal to tax publicly traded partnerships as corporations merely because their units are traded in a particular (albeit, more efficient) manner is an inappropriate singling out of one subcharacteristic (public trading) from the four characteristics for distinguishing between partnerships and associations. It is simply illogical, as well as bad policy, to make the existence of public trading the determinative factor in classifying a limited partnership for tax purposes. Why, as a manner of tax policy, should a small investor who purchases his partnership units on a national exchange be treated as a corporate stockholder for tax purposes while a large investor who sells partnership units with a much greater value through a private broker is treated as a partner for tax purposes? The proposal clearly discriminates against the small investor.

Making public tradeability the determinative characteristic in distinguishing between partnerships and associations poses severe definitional problems. How will we determine whether a partnership interest is publicly traded? It does not seem fair, from a tax equity viewpoint, to tax a partnership as a corporation if its partnership interests are traded on an established securities market but not if its interests are traded privately, even though they trade regularly and are highly liquid. On the other hand, if the definition of public trading is made broader than trading on an established securities market, then partnerships would risk inadvertent loss of their partnership status if third parties make a public market in their partnership interests without their knowledge or consent. If the publicly traded partnerships proposal becomes law, it is surely not beyond the ingenuity of sophisticated brokers to develop highly efficient in-house trading capacities without utilizing established securities markets.

It is my understanding that initial proposals to treat publicly traded partnerships as corporations arose from concerns that such partnerships would be difficult to administer and to audit. However, since that time, the administrative problem has been substantially resolved by improved computer technology and the audit problem has been addressed in the provisions for partnership level audits adopted as part of the Tax Equity and Fiscal Responsibility Act of 1982. Indeed, at the October 24, 1983 Senate Finance Committee hearing, Deputy Assistant Secretary Pearlman expresse Treasury's belief that perceived audit problems were "eliminated or substantially reduced" by the partnership level audit provisions. Mr. Pearlman also stated that Treasury was not "aware of any significant abuses that have been linked to publicly traded limited partnerships" and that it suspected "that the reporting requirements imposed upon publicly traded and registered partnerships and the public scrutiny that these organizations receive make them less likely to engage in abusive activities than partnerships with fewer partners." In view of the fact that Treasury has determined that publicly traded partnerships do not pose particulare administrative or audit problems, it would be indeed ironic if Congress were now to enact legislation that was originally proposed and touted as a solution to these perceived but truly non-existent problems.

In conclusion, I wish to emphasize that I am proud of the development in recent years of the publicly traded partnership as a more efficient capital raising vehicle in areas of great national importance, where critical investment would not be made but for the opportunity to do so through a partnership. This vehicle has permitted the small investor to invest in areas previously restricted to the wealthy. The publicly traded partnership is in all respects a partnership for stae law purposes, endowing its investors with the legal rights and obligations of partners, not shareholders. It is in all respects a partnership for tax purposes, qualifying under long established and well accepted factual criteria. That public trading by itself is not a satisfactory litmus test for determining corporate status is underscored by the ironic fact that over 98 percent of all U.S. corporations today are not themselves publicly traded. The proposal—which would only penalize certain more efficient limited partnerships that offer special investment opportunities to small investors—is an unacceptable form of legislative Luddism: if it works better, shut it down.

Arthur Andersen & Co.,
Office of Federal Tax Services,
Washington, D.C., February 28, 1984.

Hon. Dan Rostenkowski,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, D.C.

Dear Mr. Rostenkowski: These comments are submitted in response to your announcement #PR 19. While we have many clients that would be affected by these proposals, this submission is not made in behalf of any client, but instead represents our thoughts on these issues as an international accounting and consulting organization. The attached memoranda addresses the so-called accounting "abuses," funding of voluntary employee beneficiary associations (VEBA's), corporate reforms, and transfers to foreign corporations under Section 367.

The perceived accounting abuses that Treasury and the Committee dealt with under existing statutory and judicial principles. Most notable is the clear reflection if income standard embodied in Internal Revenue Code Section 446(b) that has been effectively utilized by the Internal Revenue Service and the courts to define the limits of acceptable accrual method of tax accounting. New enforcement tools such as the substantial authority provisions, the abusive tax shelter program and the "more likely than not" standard for tax shelters are also available. The Internal Revenue Service need not wait for litigation to further define these concepts. Published rulings could be issued to express IRS views and provide more guidance to taxpayers.

Moving to a hybrid accounting method that accrues income but allows deductions only on an as-paid basis is not a solution to the perceived abuses. It is a revolutionary concept that has undue complexities and appears driven by revenue considerations rather than a desire to correct abuses.

In view of the nature of the proposed changes and their complexity, caution is urged with respect to transitional rules. Inasmuch as this legislation would substantially change the economics of transactions already undertaken it is urged that appropriate grandfathering provisions be adopted. For the same reasons, any new legislation in these areas should provide an effective date for transactions completed after December 31, 1984, or subject to a binding obligation as of that date.

The goal to recognize time value of money concepts is laudable, but unfair or unrestrained legislation is destined to undermine the self-assessment system. Sweeping revisions of the current tax accounting system should be considered only as a last resort.

The proposed legislation concerning voluntary employee beneficary associations is unnecessary, since adequate safeguards are provided within the current statute, rulings regulations, and case law to deal with abusive practices. Substantial legislative action in this area should not be undertaken without further study.

In the corporate area, the most far reaching provision relates to the taxation of dividend distributions. This proposal will significantly increase the incidence of double taxation. This burden will particularly penalize the owners of small and closely held businesses. The proposal also provides disincentives for use of the corporate from since effectively it will increase tax tates. There are numerous nontax considerations involved in choosing the corporate form and it seems unreasonable to impose artificial tax disincentives to using that form of doing business. These problems could be solved by more narrowly drawn rules, as outlined in the attached memorandum.

The proposals to restrict transfers of property to foreign corporations are too expansive and are unnecessary. Again, there is adequate existing statutory and regulatory authority to assure that transfers are made for valid business reasons. The proposed restrictions would unduly hamper international business activity, could result in double taxation and could be counterproductive.

The comments on tax accounting were prepared by Richard A. Helfand, 33 West Monroe Street, Chicago, Illinois 60603, (312) 580-0033. The comments on VEBA's were prepared by Sol J. Upbin, 1345 Avenue of the Americas, New York, New York 10105, (212) 708-4263. Earl C. Brown, also of Chicago, prepared the comments on corporate tax returns. R. Jeffrey Preston, 777 East Wisconsin Avenue, P.O. Box

1215, Milwaukee, Wisconsin 53201, prepared the comments on Section 367. Questions can be addressed to any of them.

Very truly yours,

BYRLE M. ABBIN,
Managing Director.

STATEMENT REGARDING DEFERRED PAYMENT AND PREMATURE ACCRUAL PROPOSALS

This statement addresses the deferred payment and premature accrual proposals that were included in the Administration's fiscal year 1985 budget. These proposals were described in a pamphlet released by the Joint Committee on Taxation and in a General Explanation released by the Treasury Department on February 17, 1984. Since the explanations of the principles underlying the proposed legislation have only recently been released, our comments must necessarily address the general concepts contained in these proposals.

While there is theoretical merit in the objectives of these proposals, in application they would impose an unacceptably broad and complex version to long established tax accounting principles. Accordingly, we recommend that:

(1) Proposals broadly encompassing premature accruals should not be adopted. Should a determination be made that deductions for a particular accrual are inappropriate, specific legislation addressing that accrual should be enacted.

(2) If the rules concerning premature accruals are adopted as proposed, then deductions for payments to a reserve fund should be permitted in certain circumstances.

(3) Effective date provisions should grandfather existing transactions and provide appropriate opportunity to evaluate the effects of the legislation prior to its application. We suggest that any new legislation in these areas apply transactions completed after December 31, 1984, which were not subject to a binding obligation as of that date.

(4) The rules relating to deferred payment transactions should be enacted but should be limited in application to transactions involving tax shelters. Furthermore, proposals for the determination of an applicable test rates should be simplified.

GENERAL COMMENTS

With minor exceptions, our tax accounting system ignores the time value of money for items of income or deduction. The failure of the current system to recognize the time value of money can probably be attributed to two factors.

First, it is only within the last 10 years that market interest rates have been high enough to dramatically impact the present value of deferred income or deductions. As a consequence it was unnecessary to adjust the focus of the tax accounting system from its reliance on historical costs for the relatively minor distortions that resulted from the failure to present value.

Secondly, it is widely recognized that any effort to incorporate value concepts by adjusting the monetary value of income and deductions would add complexities to the tax laws for both the governments and taxpayers, especially smaller taxpayers. Experience has demonstrated that time value of money concepts can be a dangerous trap for the unsophisticated taxpayer. Congress recognized that fact when it passed the Installment Sales Revision Act of 1980. In that legislation, the 30% limitation on the amount of consideration received in the year of sale for certain installment sales was repealed, primarily due to the fact that the presence of imputed interest often caused taxpayers inadvertently to receive excesss consideration in the year of sale. Obviously, efforts to introduce these concepts as fundamental principles of tax accounting potentially affecting all taxpayers must be approached with extreme caution.

DEFERRED PAYMENT TRANSACTIONS

The Administration's legislature proposals concerning deferred payment transactions represent a major revisions to our long standing and highly refined tax accounting system and are likely to have far broader application than the drafters envision. Besides applying to currently deductible items, these rules could potentially apply to capital assets and deferred costs such as start-up expenditures. The new rules would also conflict with the cost recovery or amortization deductions generated by these assets.

Also of concern is the possible application to inventoriable costs and the determination of the cost of goods sold. Problems of allocating deferred deductions to goods sold and still on hand could arise. Similar allocation problems could arise with respect to income reportable under installment and long-term contract tax accounting rules. Further complications could arise in connection with the application of these rules when affected assets and liabilities are sold, distributed or assumed in the context of taxable or tax-free transactions.

The proposals for the applicable test rate applied to deferred payment transactions are complex and unworkable. The use of three separate discount rates adjusted semiannually will create confusion in actual application.

Complex changes affecting all taxpayers are particularly inappropriate in view of the Treasury Department's current efforts to simplify the Internal Revenue Code in a meaningful way and thereby simplify the tax collection process. The proposed legislative changes would result in many complicated new concepts that would be difficult for taxpayers to comprehend and for the Internal Revenue Service to administer. In effect a new and complicated hybrid method of accounting would be created which could have a transitory existence.

In our view there is a necessity for and merit to the proposals for deferred payment transactions. However, these provisions should be directed at the abuses they are intended to correct rather than apply to all taxpayers and to all commercial transactions. Accordingly, we recommended that as in the case of the expense prepayment rules only tax shelters be subjected to these provisions. A tax shelter for this purpose would have the same meaning as used in the prepaid expense provisions—i.e., (1) a partnership or other enterprise (other than a corporation which is not an S Corporation) in which interests have been offered for sale, at any time, in any offering required to be registered with a federal or state agency; (2) a partnership or other enterprise if more than 35% of the losses are allocable to limited partners or limited entrepreneurs (generally investors who do not actively participate in the management of the enterprise): or (3) a partnership, entity, plan or arrangement which is a tax shelter within the meaning of Section 6661(b) (i.e., the principal purpose of which is the avoidance or evasion of federal income tax). This recommendation is similar to recent Senate Finance Committee proposals.

In making this recommendation we recognize that certain taxpayers may be permitted current deductions for amounts payable in the future, overstating the true cost of the expense when taking into account the time value of money. On the other hand, the acquisition of fixed assets or inventories and the subsequent charge of costs to depreciation or cost of goods sold also ignore time value of money concepts. A taxpayer paying current dollars for these items may not be entitled to a deduction for these expenditures for several years. Similarly, items of accrued income, such as sales and service income or income settlements, that may not be received for several years are reflected in taxable income using current dollars rather than their present value. Proposals dealing with only limited aspects of the time value of money issues are unfair to taxpayers and cannot be theoretically supported.

PREMATURE ACCRUALS

A basic concept underlying accrual method accounting is the matching of revenues with costs associated with the earning of such revenue. In an early tax decision the Supreme Court held that taxpayers should be permitted to use the accrual method of accounting, hence to charge against income earned during the taxable period, the expenses incurred in earning income during that period.

In various circumstances the Internal Revenue Service has noted the importance of this matching concept indicating that it is inherent in the concept of clear reflection of income. The Internal Revenue Service has indicated that the accrual method of accounting accurately reflects the annual increase or decrease in the asset, liability, and net worth position of a company as shown on its books and records, and as verified by its financial statements.

The premature accrual proposal would violate this matching concept by deferring deductions in certain circumstances substantially beyond the period in which related income would be reported. This would apparently be accomplished by redefining the all events test to defer deductions that presently clearly meet the test and are permissible rather than "premature" deductions. The proposal attempts to deal with this distortion by expanding the net operating loss carryback provisions. The operation of these provisions suggests that the premature accrual legislation is improper and unnecessary. Indeed, these expanded provisions recognize the economic fact that the deductions in question relate to income that would have already been reported.

The premature accrual proposal also represents a significant departure from financial accounting principles. Although financial and tax accounting have divergent goals, the numerous similarities between the two methods have permitted financial accounting income to act as a strong foundation for the determination of taxable income and an aid in the adminstration of our tax system. Present Treasury regulations reinforce this principle by providing that "a method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income provided all items of gross income and expense are treated consistently from year to year."

If the premature accrual proposal and other measures, such as the proposal relating to deferred payments, are enacted, it is clear that such reliance on financial accounting could not continue. Accordingly the burden on both taxpayers and the government in complying with the new system would be substantial. One of the fundamental strengths of our present tax system is the high degree of compliance on a self-assessment basis. This aspect of our tax laws, which is largely based upon the overall fairness of the laws, must be preserved in order to maintain the integrity of the system. The current proposals may depart from these fairness considerations.

Our understanding of the proposal to deny deductions for certain liabilities is that the "all events" test would become a three prong test requiring that "economic performance" occur in order for an amount to be deductible. Unfortunately, "economic performance" is a new and undefined term with several potential interpretations. The explanation prepared by the staff of the Joint Committee on Taxation suggests that economic performance occurs generally when services are performed, property provided, use of property occurs and in the special case of workmen's compensation or similar liability when the liability is satisfied. We understand that the deferred payment proposal and the premature accrual rules could apply consecutively to the same transaction. Once economic performance occurs, the deferred payment rules would apply to allow the taxpayer a discounted deduction at that time with the balance constituting interest expense allocated over the remaining period until ultimate payment. The possible application of both the premature accrual and deferred payment rules to a single transaction represents an extraordinarily complicated tax accounting result.

For example, if a taxpayer entered into an agreement to rent property for five years with all of the rent being due at the end of the rental period, a premature accrual could initially result. However, as time elapsed economic performance would presumably begin to occur thereby triggering application of the deferred payment rules as the that element of the obligation. Presumably the necessary computations involved in the switch from premature accrual to deferred payment treatment would occur on a periodic basis, perhaps monthly. With changing interest rates and the declining amount of the remaining premature accrual, the amount of the taxpayer's annual deductible expense could fluctuate significantly even though such fluctuations would not have been present had interest been explicitly provided on the unpaid rent. It is obvious that these rules would become the source of substantial litigation, even assuming timely issuance of regulations defining the interrelationships and fundamental nature of these concepts.

The premature accrual concept will also likely frustrate public policy goals pursued by Congress, other agencies of the federal government or agencies of state and local government. Many of the perceived areas of concern discussed in the report of the Joint Committee on Taxation involve compliance with federal, state and local government mandated programs designed to accomplish important social objectives. These include expenditures for mining reclamation, nuclear power plant decommissioning, workmen's compensation and other similar expenses. Deferring deductions for these programs is inconsistent with the underlying objectives for which they are required and with the concept that affected taxpayers have a social obligation to incur future costs associated with their current income producing activities.

It is important to note that several bills are pending that would permit either a current deduction for these liabilities or a currently deductible contribution to reserves established for the ultimate payment of these liabilities. Inherent in these bills is an understanding that public policy objectives have created undue economic hardship for certain industries. It is ironic indeed that legislation affecting all taxpayers is being considered because of concerns about deductions for reclamation expenditures, nuclear decommissioning costs, etc., while at the same time Congress is also considering exempting these transactions from the application of this legislation.

For these reasons we have concluded that the premature accrual proposals are contrary to well defined and accepted tax accounting principles and should not be adopted. Rather than dealing directly with the specific issues involved, the administration has proposed sweeping legislation that would remove an important element of accrual method reporting. However, should these proposals be adopted we strongly urge that in certain circumstances taxpayers be permitted to make deductible contributions to reserve funds to provide for the payment of long-term liabilities in an orderly manner.

STATEMENT REGARDING VOLUNTARY EMPLOYEES' BENEFICIARY ASSOCIATIONS (VEBA)

Numerous employers have established VEBA's as a valid and effective cash management tool designed to provide employees with permitted fringe benefits. The utilization of these VEBA's has been approved by the Internal Revenue Service and has been consistent with current laws. We do not believe abusive practices exist that could not be dealt with under the current statute, regulations, revenue rulings and case law. Therefore, we do not believe legislative change is warranted at this time.

The current regulations dealing with VEBA's specifically provide that eligibility requirements must be based upon objective and reasonable standards, and that benefits may not be disproportionate where not paid pursuant to objective and reasonable standards. The Service has been able to enforce these standards through the exemption application procedures and case examinations. Thus, additional legislated restrictions are not needed to resolve the concerns with discrimination as to participation, and availability, utilization and distribution of benefits.

The proposal redefines allowable benefits in a VEBA, specifically indicating that vacation pay would fit within the definition of a benefit essentially equivalent to wages if contingent upon the performance of additional services for the employers. This proposal is too broad in that it does not distinguish between base-level benefits and additional benefits provided due to length of service and/or position classification. At a minimum, base-level or per capita benefits should be permitted in a VEBA. For example, if vacation pay is provided using a standard unrelated to service and position, viz., all employees are entitled to two weeks vacation, then VEBA is an appropriate funding mechanism for providing this benefit. This concept should apply to all benefits contingent upon performance of additional services.

No change in prefunding concepts is necessary or indeed desirable. Funding of a VEBA is currently permitted by the Service only if amounts are reasonable, made on a level annual basis and are actuarially (or its equivalent) determined. If these concepts are modified, numerous VEBA's could be underfunded and short of cash when benefits are payable. Thus, benefits promised to employees might not be realized by them.

On balance, adequate protections exist in the statute, regulations, rulings, case law, and the exemption and examination process to ensure the nondiscriminatory operation of VEBA's. These authorities also ensure funding under actuarial principles, that properly limit prefunding and prevent unreasonable reserves. We do not believe legislative action is necessary in this area at this time on in the absence of further study.

STATEMENT REGARDING CORPORATE REFORMS

Because the proposals for corporate reform contained in the Joint Committee Summary of Administration Revenue Proposals (Summary) are primarily conceptual in nature and do not detail the statutory language that would be used in foreclosing certain perceived abuses, we will limit our comments to three of the areas discussed in the Summary. We will comment on the balance of the proposals when specific statutory language is drafted.

LEVERAGED STOCK INVESTMENTS

We agree that the operation in tandem of the corporate dividends received deduction and the interest deduction provides a potential for abuse. The difficulty in legislating in this area is to distinguish effectively between abusive and nonabusive fact situations. In this regard, we are encouraged by language in the proposals suggesting that the interest deduction limitation will not automatically follow where the corporation holds portfolio stock, but will be restricted to those cases where the debt would not have been incurred but for the stock investment.

In addition to this overall restriction on the interest deduction limitation, we believe that a de minimis rule might also be included as an exception to the proposed interest deduction limitation. For example, interest deductions of a corporation up to a specific dollar amount would be presumed to stem from debt incurred for reasons other than a stock purchase. The inclusion of such a de minimus rule in the leveraged stock investment proposal would result in a more easily administered provision that would nevertheless reach the abusive situation and satisfy the proposal's policy concerns. In addition to such a de minimis rule, we believe that in no event should the amount of interest disallowed under this proposal exceed 85% of the amount of dividends received by a corporation on its leveraged stock investment.

ACCUMULATED EARNINGS

The proposal would make adjustments to the manner of computing the accumulated earnings tax and would seek a declaration that the accumulated earnings tax applies to publicly traded corporations.

The Summary outlines in some detail the mechanism that has been used by certain investment companies. The tax advantage of these arrangements is possible under current law not because publicly traded companies are exempted from the accumulated earnings tax but rather because investment companies' net capital losses may be used to reduce accumulated earnings taxable income.

Publicly traded companies may be subject to the accumulated earnings tax under current law. However, public companies rarely fall within the ambit of the tax because their boards of directors are bound to some degree to serve the dividend demands of their electing shareholders. Accordingly, we agree with the proposal to the extent that it denies the special deduction of net capital losses from accumulated taxable income in the case of mere holding companies and investment companies. However, we do not believe the proposal should go so far as to declare that the accumulated earnings tax applies to all publicly held corporations.

DIVIDENDS DISTRIBUTIONS

Under this proposal, dividend distributions of appreciated property would be taxed not only at the shareholder level, but also at the corporate level. The corporation would be taxed on recapture as well as on all appreciation of the property distributed, as if the property had been sold.

Our first response to this proposal is that it would amount to a significant expansion of the system of double taxation. In fact, this proposal follows in the wake of the Subchapter S Revision Act of 1982, an Act promoted in part by a policy of expanding the single-tier system of business taxation.

The potential expansion of double taxation under the proposal can be illustrated by the following simple example. Assume Corporation X purchased a parcel of real estate for $4,000 in 1980. In a later year, Corporation X chooses to distribute the property to its shareholders as a dividend in lieu of cash. Under current law, assuming the property is valued at $10,000 at distribution and assuming the corporation has earnings and profits, the only tax on the transaction occurs at the shareholder level (50% × $10,000 = $5,000). Under the proposal, however, in addition to the same shareholder tax, the corporation will be taxed on the appreciation in value of the land (28% × $6,000 = $1,680). The combined tax rate in this case where the corporation has basis in the distributed property is, therefore, 66.8%.

The tax rate imposed on the appreciation element, however, could be even greater. For example, under current law, dividend distributions of appreciated property are taxed at a maximum rate of 50% of the value of the property. Under the proposal, in the typical case of a mature corporation with accumulated earnings and profits, the appreciation element in the value of in-kind distributions of capital and ordinary assets could be taxed at rates of 78% to 96%. (Capital assets—($100 × 28% = $28) + ($100 × 50% = $50) = $78) (Ordinary assets—($100 × 46% + $46) + ($100 × 50% = $50) = $96).

Our second concern with this proposal is that it provides additional disincentive to the use of the corporate form. This is due to the fact that enactment of the proposal would result in a higher overall tax rate than if the business had not been incorporated.

The burden of this proposal and the consequent pressure against incorporation will be borne primarily by privately held, small businesses. In the publicly held setting, economic and practical considerations rarely justify dividend disributions of property other than cash. The burden to the closely-held corporation becomes more onerous if the corporation was originally formed to hold assets previously held by a partnership or proprietorship. The assets contributed at formation of the corporation may have already appreciated substantially in value, from inflation or otherwise, and intangible asset values may have arisen prior to incorporation. The proposal would tax this preincorporation gain on a dividend distribution of these assets. The obvious result is that the shareholders would pay a much greater tax on removal of selected assets from the business than if no corporation had been formed. Although the S corporation election may provide relief for some businesses, many others will be unable to qualify for S corporation status.

An additional concern we have with the distribution proposal is that it would amend the general nonrecognition rules for corporate distributions only in the case of distribution of appreciated property. Dividend distributions have traditionally come within the language of Section 311(a), which provides that no gain or loss shall be recongized to a corporation on distributions with respect to its stock. If dividend distributions of appreciated property are stricken from this nonrecognition rule to achieve parity with a sale, we believe property which carries unrealized losses should be subject to the same rule.

If this proposal is ultimately enacted, it should be accompanied by some relief, perhaps in the form of a shareholder credit for tax incurred by the distributing corporation. In the liquidation context, the American Law Institute recognized the severity of a double tax on a distribution on long-term appreciation in the value of business assets. In response, the Institute proposed a credit against shareholder level tax equal to the shareholder's proportionate share of corporate tax paid on capital gain items distribute in liquidation. Although the computation and administration of a shareholder credit might be difficult, it would serve to mitigate the harsh results which will otherwise ensue from enactment of this proposal.

Finally, the proposal as contemplated in the Summary is more encompassing than the abuse that fostered its drafting. The thrust of the majority of the Treasury proposals is directed toward abuses available under existing law. We believe that the "abuse" in the distribution area results not from avoidance of double taxation but from those situations where a nonliquidating distribution is accompanied by no tax or a shareholder capital gain tax because the distributing corporation has no earnings and profits. Accordingly, we would urge as an alternative to the proposal a rule that nonliquidating distributions of appreciated property will generate earnings and profits to the distributing corporation as if the property had been sold by the corporation. This alternative would result in ultimate dividend taxation at the shareholder level and would not introduce the host of problems cited above.

STATEMENT REGARDING TRANSFERS OF APPRECIATED PROPERTY TO FOREIGN CORPORATIONS

The Administration's proposal to alter the rules governing transfers of property abroad to provide gain recognition in certain instances without regard to purpose is unnecessary and counter-productive.

The purpose of Section 367(a) is to allow multinational business to be conducted in the same manner as domestic business as long as there is no principal U.S. tax avoidance motivation. Transfers of property outside the U.S. pursuant to the enumerated reorganization provisions can only be done with approval of the Internal Revenue Service. Most outbound transfers are done for valid business reasons that should not be discouraged or restricted. For those transactions where a principal purpose of U.S. tax avoidance exists, the Internal Revenue Service has adequate means to prevent deferral of gain recognition, see Rev. Proc. 68-23, 1968-1 C.B. 821, and the closing agreement procedures.

There is no reason to restrict outbound transfers of assets where a valid business purpose exists and there is no U.S. tax avoidance motive. The facts of the *Kaiser Alumimum* case, 76 T.C. 325, present a prime example of a transaction done for valid business reasons that would be prevented by the Administration proposal.

Furthermore, with the emerging foreign markets of U.S. high technology companies, there are often valid business reasons for the transfer of technology for use by foreign affiliates. If the transfer is for U.S. tax avoidance purposes, the Internal Revenue has the ability to tax the transfer. If the taxpayer disagrees with the Internal Revenue Service's determination, the declaratory judgment procedures of IRC Section 7477 can be utilized. In *Kaiser Alumimum,* the Tax Court found that the outbound transfer was motivated by valid business reasons and did not have a principal purpose of tax avoidance. If the transaction were between domestic companies no restriction would occur. There is no reason to require current taxation merely because the transferee is a foreign corporation instead of a domestic corporation unless a tax avoidance principal purpose is present. Elimination of the tax avoidance test would limit the ability of multinational companies to freely reorganize their structures to meet business needs.

Finally, the imposition of an active conduct of a trade or business test on outbound transfers of stock would eliminate the ability of taxpayers to form foreign holding companies. The Internal Revenue Service's own ruling guidelines allow such transactions where the "same country" exception of Section 3.02(1)(a)(iii)(B) of Rev. Proc. 68-23 is met.

The Administration's proposal also seeks to codify the Service's Revenue Ruling 78-201, 1878-1 C.B. 91 and Revenue Ruling 80-246, 1980-2 C.B. 125. These rulings require recapture of certain losses upon the incorporation of a foreign branch by a U.S. person without regard to whether such incorporation had as a principal purpose the avoidance of U.S. income tax. Thus in *Hershey Food Corp.* v. *Com'r,* 76 T.C. 312, the Service contended that the foreign branch losses of Hershey were required to be recaptured even though the Tax Court found that the incorporation of the foreign branch was motivated by valid business purposes. The Service was apparently concerned more with the potential for abuse, rather than whether an unwarranted tax benefit was accomplished. The abuse perceived by the Service is apparently that the past foreign branch losses were used to offset the U.S. person's income subject to U.S. tax and that the future income of the incorporated branch will not be subject to curent U.S. income tax.

The Service's concern is unfounded since the Internal Revenue Code already contains sufficient provisions to prevent abouse in this situation. Section 904(f)(3) of the Internal Revenue Code already requires recapture of excess foreign losses upon incorporation of a foreign branch. Foreign losses are first offest against foreign source income and thereby reduce allowable foreign tax credits. Any excess loss that reduced U.S. source income will be recaptured. As noted below by the Tax Court in *Hershey,* adoption of the Service's position would lead to an inequitable result:

"If we were to sustain respondent's position, we would be counting Hershey's Canadian branch losses against it twice—first, to reduce other foreign income and thus reduce foreign tax credits and, second, as additional foreign source income. In effect, we would undermine the whole rationale behind the foreign tax credit system—the prevention of double taxation." *Hershey* 76 TC 312, 324.

Furthermore, the fact that future income of the incorporated foreign branch is not subject to current U.S. tax should not be considered as an abuse where the incorporation is motivated by valid business purposes. U.S. based multinationals should not be restricted from expanding their foreign operations merely because foreign losses have been incurred. There is no difference between a domestic corporation's incorporation of a foreign loss branch and the incorporation overseas of a foreign profit branch; in both cases only income yet to be earned is removed from U.S. taxation.

Arthur Andersen & Co.,
Office of Federal Tax Services,
Washington, D.C., February 16, 1984.

Hon. Daniel Rostenkowski,
Chairman, Committee on Ways and Means,
Longworth House Office Building, Washington, D.C.

Dear Mr. Chairman: These comments are submitted in response to Press Release #19 of the Committee on Ways and Means and with respect to the hearings on Administration and other proposals concerning tax shelters, accounting abuses and corporate and securities reforms. While we have many clients who will be affected if the proposals are implemented, this submission is not made on behalf of any client, but instead, represents our recommendation as an international accounting and consulting organization.

At this time, we will confine our comments to one issue in particular, namely the proposal to amend Internal Revenue Code Section 704(b) to prohibit any allocation of an item of partnership income, gain, loss or deduction in a manner disproportionate to the allocation of partnership net income. This proposal has been referred to commonly as "the limitation on special allocations" and has been discussed in connection with various other proposals characterized as tax shelter provisions. While we understand that the Administration does not currently advocate this particular proposal we believe that this Committee should clearly understand how damaging this proposal would be to normal business operations carried on in the partnership form.

Special allocations are essential to the clear reflection of the economic and legal arrangements of many partnerships. The proposed limitation seeks to require a proportionate sharing of risk among partners and would deny tax deductions to some partners who agree to assume a disproportionate share of the risk and related costs of a business venture. Furthermore, under the proposal, partners could be taxed on income they were never entitled to receive.

In short, by disregarding the underlying economic and legal arrangement of the partnership's business, the proposal would reverse the principle that tax rules and taxation should follow, rather than dictate, the economics of a transaction. This would have a serious adverse impact on the formation of risk capital and the equitable sharing of income commensurate with risk assumed and skills applied.

We believe that existing provisions in the Internal Revenue Code and Treasury regulations contain appropriate protection against improper partnership allocations. Furthermore, eliminating special allocations is not likely to reduce the marketing of abusive tax shelters as they are not an essential element of those schemes.

The accompanying statement further explains the reasons for our opposition to this proposal. The statement also contains examples of common situations in which special allocations of partnership items of income and expense are essential to reflect the business arrangement. We would be pleased to respond to any requests for additional information by the Committee or its staff.

Very truly yours,

BYRLE M. ABBIN,
Managing Director.

Attachment.

STATEMENT REGARDING PROPOSAL TO ELIMINATE SECTION 704(b) SPECIAL PARTNERSHIP ITEM ALLOCATIONS

Taxpayers who select the partnership form of conducting business usually enter into a formal contract (partnership agreement) to evidence the manner in which they agree to share the benefits and burdens of the business they will own and operate jointly. The partnership agreement typically will define the allocation of partnership income and losses among the partners. In many situations, the partners agree that a particular item of partnership income, gain, loss of expense will be shared in a manner disproportionate to that in which the partners generally share partnership profits and losses.

Internal Revenue Code ("Code") § 704(b) provides that allocations of partnership income, gains, losses and deductions and *items thereof* set forth in a partnership agreement are valid for income tax purposes if such allocations have "substantial economic effect." Generally, this means that if, ignoring income tax consequences, allocations significantly affect the partners economically, such allocations will be respected for tax purposes. This concept follows a basic principle of tax law that a taxpayer must bear at least a risk of loss to obtain tax deductions and losses and be able to enjoy the benefits of the gains and income if he is required to declare them as taxable income.

It has been reported that the Senate Finance Committee and certain members of the House of Representatives are considering proposals to amend Code § 704(b) to prohibit any allocation of an *item* of partnership income, gain, loss or deduction in a manner disproportionate to the allocation of partnership net (bottom line) income. Disproportionate item allocations generally are referred to as "special allocations." Further, it is our understanding that the proposal is grounded in the belief that special allocations are a key factor in structuring most abusive tax shelters or that their use is motivated primarily by tax considerations.

It is our conclusion that the treatment of special allocations and the effort to curb abuses must focus on the validity or invalidity of the items to be allocated—not the manner in which the items are allocated. We consider this to be necessary for four important reasons.

First, eliminating special allocations is not likely to reduce the marketing of abusive tax shelters.

Second, special allocations are essential to the clear reflection of the economic and legal arrangement of many partnerships.

Third, the Code and regulatory authority presently contain appropriate protection against improper allocations.

Fourth, and perhaps most importantly, a proposal such as this that would apply by its terms to all partnerships, even though designed to affect primarily abusive tax shelters, has enormous potential for unintended harm. This is due simply to the fact that extensive economic activities are carried on in the partnership form. Many commercial and professional service businesses operate in partnership form. Moreover, billions of dollars of capital are raised and committed each year through partnerships for developing real estate (including housing, hotels, hospitals and commercial buildings), exploring for sources of energy and for research. It has been stated by investment analysts that a substantial portion of these investments generate taxable income currently and do not fit into the typical "tax shelter" mold.

Treasury Department statistics for 1980 show that of the nearly 1.4 million partnerships filing tax returns, only 12 percent were limited partnerships, the most common form of organization for a tax shelter (whether or not an "abusive" tax shelter). In addition, 56 percent of all partnership tax returns reported net taxable income in 1980. Thus, any proposal that would generally deny partnerships the flexibility to recognize the economic and legal effect of risk allocation would have a substantial, adverse impact.

The balance of our statement further explains our objections to a general prohibition against special allocations.

Relationship of special allocations to abusive tax shelters

An abusive tax shelter contemplates a structure that contains an artificial element at some point in the scheme. The artificial aspect might be a nonrecourse debt that grossly exceeds the value of the property pledged as security, a recourse debt payable by a "judgment-proof" obligor, a "business" operation with little or no potential for profit other than through tax reductions or deferrals, a risk-free transaction designed to convert ordinary income to capital gain, an accounting technique that does not accurately reflect the facts or some similar technique.

The artificial element is essential to the abusive scheme. The use of a special allocation is not essential to accomplishing the objective of the abusive shelter. The timing of a partnership taxable loss in an abusive tax shelter arrangement usually is very predictable. In certain circumstances, the timing of losses is substantially within the control of the general partner. In situations where there is little or no potential for profit, other than through tax reductions, the scheme can be accomplished through a simple allocation of net (bottom line) loss to the partners to whom the shelter has been marketed. The operator or general partner will reap his profit through the receipt of a fee paid by the partnership. This fee is usually paid out of investor partner capital contributions immediately after formation of the partnership.

In summary, eliminating special allocations will not curb the marketing of abusive tax shelters because such arrangements can be easily structured without specially allocating *items* of partnership income and deductions.

Relationship of special allocations to bona fide business arrangements

Sound business ventures conducted in partnership form often involve special allocations supported by valid business purposes. These allocations may recognize the disproportionate effort or expertise of one or more of the partners and the desire to allocate income of the business venture accordingly. For example, the partners in a law firm might recognize that the income from particular clients or from a particular case, such as a medical malpractice case where the fees are contingent upon successful litigation, should be allocated disproportionately to reward the special skills of one of the partners. In another situation, a partner in a small engineering or architectural firm may choose to take two months off during the summer in order to care for his/her children, who went home during summer vacation. A special allocation of income that accrued during those months recognizes the reduced efforts of that partner and allows for a sharing of income that reflects economic realities.

It is a fact that many service partnerships are a collection of entrepreneurs with particular skills; some are more adept in technical matters, others in creative thinking or in managing, still others in promoting new client relationships. These differing talents and commitments of time and intellectual and entrepreneurial skills often dictate special risk and reward sharing arrangements. A requirement that only botton-line income may be allocated disregards the underlying equitable and business considerations that are the basis for special income and expense allocations. Indeed, such a rule would operate at best to require these partners to arrange their business agreements according to tax rather than economic considerations.

In other situations, special allocations recognize that one partner may be willing to assume the economic risk of a particular partnership activity while the other partner or partners may not be willing to do so. For example, in an oil drilling venture, the partners may disagree concerning whether a particular well should be completed or drilled to a greater depth. To resolve the dispute they may agree that the expenses of further drilling (and the possible rewards therefrom) will be allocated entirely to the more optimistic partner(s). Special allocations of expenses and resulting income (if any) will be necessary in order to reflect the additional economic risk assumed by one or more of the partners with respect to that well. In fact, it is very common for oil drilling ventures to incorporate specific provisions in the agreement that anticipate this situation and allow a partner to "sit-out" when capital for further drilling is needed.

Another situation in which a partner might agree to assume economic risk that is disproportionate to his/her share of partnership net income relates to the development of an innovative product or a new market area. The expenses for the needed research and promotional efforts as well as any resulting income should be specially allocated according to the underlying economic and business considerations. If this is not recognized, those with available funds will not participate in the venture with the result that those with an innovative idea or product often will be unable to capitalize on it.

If partners have negotiated an arrangement that recognizes disproportionate efforts, talents and risks, a tax statute that would ignore the business economics of the true, legal relationship of the parties would be inconsistent with the fundamental precept of recognizing substance over form. In fact, it would constitute a reversal of the principle that taxation should follow, rather than dictate, the economics of a transaction or agreement. Furthermore, the enactment of a provision prohibiting special allocations would affect the manner in which business arrangements are bargained. Such a provision may stifle the conduct of meaningful commercial transactions. Indeed, it would contradict a fundamental assumption of our capitalist system, *viz.*, talents, effort and risk-taking should be appropriately rewarded or punished.

Attached are more detailed examples of typical business arrangements conducted in partnership form wherein special allocations of partnership items of income and expense are essential to reflect the business arrangement. These examples are included to illustrate the realistic, economic operation of special allocation provisions and their effect.

Existing statutory and regulatory authority ensure the validity of special allocations

Code § 704(b) presently authorizes the Internal Revenue Service to reallocate partnership income and losses or items thereof if the allocations provided for in the partnership agreement do not have "substantial economic effect." On March 8, 1983, Proposed Treasury Regulations were published defining substantial economic effect and prescribing the manner in which partnership allocations are to be made in situations wherein substantial economic effect is lacking. Generally, those Regulations are designed to ensure that a partner to whom a loss or expense is allocated will, in fact, bear the burden of such loss or expense. Thus, the substantial economic effect requirement, if consistently applied by the Internal Revenue Service, will result in partnership allocations that are meaningful and that are supported by substantive business arrangements. To the extent that item allocations without substantial economic effect are being made, the proper response is for the Internal Revenue Service to enforce the tax law.

In addition to the requirements contained in Code § 704(b), the Code contains penalties for understatement of tax due to valuation overstatements (§ 6659), promoting abusive tax shelters (§ 6700), aiding and abetting an understatement of tax liability (§ 6701), and various other penalties that may be assessed for improper application of the provisions of the Internal Revenue Code.

Application to existing partnerships

The proposed disallowance of special item allocations would be particularly onerous if applied to existing partnerships. For those businesses, partnership agreements are already in place and their provisions have allocated net income or items of income and deduction in accordance with underlying legal and economic considerations. As described above, when a partner has economically assumed a disproportionate share of the burden of a particular partnership expense, and received a special allocation of the related deduction, it is often done with the expectation that he/she will receive a corresponding disproportionate share of income and distributions as well. To the extent a deduction has been specially allocated to that partner in a prior year, it is appropriate that the tax law continue to recognize the bargained-for special allocation of income. Certainly, the underlying economic considerations will require an actual distribution of that income to that partner; hence, taxation of that income should follow. It would be extraordinary, indeed, if the tax law were to be changed to require that a partner not benefitting from a special allocation of a deduction should nevertheless be taxed on related income that he/she was not entitled to receive under the partnership agreement.

This obvious inequity illustrates the severe problems that would flow from the adoption of a tax rule that disregards underlying economic realities. A requirement that income and deductions be allocated in a particular fashion without regard to business realities or legal agreements, would be cause enough for real concern, but the application of that rule to existing partnerships so as to create the likelihood that partners could be taxed on income they would not be entitled to receive would be unprecedented. A substantial number (perhaps thousands) of lawsuits among partners can be anticipated if this were to occur. For these reasons, we strongly urge that any proposed restrictions on special item allocations, if adopted, not be applied to existing partnerships.

In summary, the Internal Revenue Service has ample statutory and regulatory tools to prevent the marketing of abusive tax shelters. Since many of these were only recently enacted or promulgated, we believe that additional legislative remedies should not be considered until and unless experience shows that present curbs against abusive tax shelter arrangements are ineffective. In any event, such additional remedies as may be needed should not be formulated in a manner that would interfere with the ordinary conduct of valid business arrangements and should not be applied to existing partnerships.

EXAMPLE 1.—PARTNERSHIP SPECIAL ALLOCATIONS, OIL AND GAS EXAMPLE

Partnership XYZ owns producing Property A, which generates $300 net taxable income during the year. The partners share equally in the revenues and expenses of this property. The partnership drills a well on Property B. Under a common "carried interest" arrangement, Partners Y and Z agree to pay all of the costs to drill the well on Property B and will receive all of the net income from such property until they have recouped an amount equal to costs incurred. At such time (commonly referred to as "payout"), the partners will share equally in all revenues and expenses of that property.

Assuming the following revenue and expense amounts, under existing Section 704(b) (providing the allocations have substantial economic effect) the partners would report taxable income or loss as follows:

	X	Y	Z	Total
Net taxable income—Property A	$100	$100	$100	$300
IDC and depreciation—Property B	(–)	(300)	(300)	(600)
Net revenues—Property B	–	30	30	60
New taxable income (loss)	100	(170)	(170)	(240)

Item allocations reflect the partners' economic arrangement in that Partner X is entitled to $100 cash (his share of Property A income) and reports a comparable amount of taxable income. Partners Y and Z report net taxable losses equal to their net economic participation in the partnership. Y and Z contributed cash to fund their Property B drilling obligations and are entitled to cash in accordance with the agreed sharing in Properties A and B.

If item allocation is not permitted, the "bottom line" taxable loss would be allocated as follows: Net taxable loss—X, ($80); Y, ($80); and Z, ($80); for a total of ($240).

Partner X will report a taxable loss even though his share of partnership equity has increased. He will not report income unless and until his cash withdrawals exceed his adjusted basis in his partnership interest. All or part of such excess may be long-term capital gain. Partners Y and Z, who bore the economic risk that Property B might be nonproductive, do not receive a deduction for the decrease in their equity accounts. Upon termination of the partnership, they may have a deduction for their remaining basis, but such deduction likely will be a long-term capital loss.

EXAMPLE 2.—PARTNERSHIP SPECIAL ALLOCATIONS, REAL ESTATE EXAMPLE

Partnership A & B is formed with Partner A contributing $3,000 and Partner B contributing $1,000. The partnership acquires land and a building for $4,000 in cash, with no financing involved. Due to his concern regarding the risk of the project, Partner A insists that the partnership agreement provide for him to receive a priority distribution of partnership cash flow of $200 per year. Thereafter, cash flow from operations will be divided evenly. Upon sale or refinancing the first $4,000 will be divided 75 percent to Partner A and 25 percent to Partner B, with any excess divided evenly.

In year one, the partnership receives $1,000 in rental income and pays $800 in expenses. Depreciation is $200. The $200 in cash flow is distributed to Partner A in accordance with the partnership agreement. There is no taxable income. In the beginning of year two, the land and building are sold for $3,800, which is its tax basis.

The proceeds are distributed $2,850 to Partner A and $950 to Partner B, in accordance with the agreement and the partnership is liquidated.

If no special allocation of items are allowed, the partners capital accounts would reflect the following:

	Partner A		Partner B	
	DR	CR	DR	CR
Initial capital		$3,000		$1,000
First year taxable income				
First year cash flow distribution	$200			
Gain in sale				
Cash from sale	2,850		$950	
Total	3,050	3,000	950	1,000
Capital accounts	50			50

The capital account balances after liquidation confirm the fact that the economics of the partnership agreement have not been reflected in tax returns.

Improper capital accounts result because Partner A has been allocated $50 of depreciation that economically was suffered by Partner B. Under present law it would have been appropriate in the partnership agreement to require the operating cash flow and operating taxable income to be allocated to Partner A (up to $200 per year), and for the depreciation to be allocated 75% to Partner A and 25% to Partner B. Partner A would have reported taxable income of $50 and Partner B would have reported a $50 loss. Under the proposed prohibition against special allocations, Partner A reports no ordinary taxable income. Instead, he will report $50 of capital gain and Partner B will report a $50 capital loss.

EXAMPLE 3.—PARTNERSHIP SPECIAL ALLOCATIONS, PROFESSIONAL SERVICES EXAMPLE

Partnership CDE is an architectural firm that provides professional services for its clients. The partners share equally in the revenues and expenses of the business, except that 15% of fees received from Client L are allocated and distributed to Partner E. This is in recognition of the fact that Client L was a client of Partner E before he pointed the firm, and that Partner E devotes approximately 50% of his time to that client. The Partnership receives $300,000 in revenues during the year, $90,000 of which are from Client L. Operating expenses are $150,000.

Under existing Section 704(b) (providing the allocations have substantial economic effect) the partners would report taxable income as follows:

	C	D	E	Total
Income from client L—15 percent allocated to partner E			$13,500	$13,500
85 percent allocated evenly	$25,500	$25,000	25,500	76,500
Other revenues	70,000	70,000	70,000	210,000
Expense	(50,000)	(50,000)	(50,000)	(150,000)
Net taxable income	45,500	45,500	59,000	150,000

The permitted special allocation recognizes the fact that taxable income should be allocated in accordance with the benefits to be realized—in this case, the distribution of net cash received.

If item allocations are not permitted, the taxable income of the partnership would be allocated evenly, $50,000 per partner. Partners C and D would be allocated evenly, $50,000 per partner. Partners C and D would each be taxed on $4,500 income that would never be distributed to them.

EXAMPLE 4.—PARTNERSHIP SPECIAL ALLOCATIONS, ADMISSION OF NEW PARTNER

Partnership FG engages in the practice of law. The partners specialize in different area of the law, but have agreed to share equally all net income, computed on the cash basis. Partner H was admitted as a new partner on January 1. According to the partnership agreement, fees for unbilled and uncollected services as of the beginning of the year will be allocated and distributed to Partners F and G. Otherwise, income will be shared equally by the three partners. The partnership reports its income using the cash receipts and disbursements method.

Assuming the following revenue and expense amounts, under existing Section 704(b) (providing the allocations have substantial economic effect) the partners would report taxable income as follows:

	F	G	H	Total
Contingent fee for judgment in products liability case begun 5 years before	$300	$300		$600
Net revenues for current years' services	70	70	70	210
Net taxable income	370	370	70	810

Because cash distributions will be in accordance with this allocation, the taxable income reported by each partner will reflect the underlying economic realities.

If item allocations are not permitted, and "bottomline" taxable income of the partnership were allocated evenly, new Partner H would be allocated $270 of taxable income, but would be entitled to receive only $70. This result is clearly contrary to the economic substance of the sharing agreement and it is unlikely that, under these rules, H would ever aspire to become a partner in this firm.

EXAMPLE 5.—PARTNERSHIP SPECIAL ALLOCATIONS, PRIOR APPRECIATION EXAMPLE

The only asset of Partnership AB is a building with a basis of $200 and a fair market value of $300. In order to raise operating capital, Partner C is admitted and contributes $150 in exchange for a 50% interest in the profits of the partnership.

The partnership operations during the following year produce neither gain nor loss, after taking into account the $14 of depreciation attributable to that period. At that point, the building is sold for $300 and the partners receive a cash distribution based on the appreciation in the value of the building which occurred during the time they held their respective partnerhip interests. As a result, the gain of $114 is distributed as follows:

Partners A + B	$107
Partner C	7
Total	114

If item allocations are not permitted, Partner C will be allocated 50% of the gain, or $57, and would pay tax on that amount. This would occur in spite of the fact that the only "gain" attributable to the period during which he was a Partner relates to $14 of depreciation expenses and in spite of the fact that he received only $7 as his share of the total gain.

JOINT STATEMENT OF GERALD H. SHERMAN AND STUART M. LEWIS, COUNSELS, ON BEHALF OF THE ASSOCIATION FOR ADVANCED LIFE UNDERWRITING AND THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS

SUMMARY

Compensation-related items being considered by the Committee should not be adopted at the present time. There has been inadequate notice to the public concerning these proposals, inadequate time for the public to evaluate and respond to these proposals and inadequate detail furnished to the public concerning the proposals themselves.

The Internal Revenue Service should not be permitted to undermine the treatment of cafeteria plans as they have been adopted since 1978 or to require the elimination of cash options in cafeteria plans.

No modification should be adopted at the present time in the treatment of cash or deferred arrangements under section 401(k). Neither the definition of "hardship" nor the rules for computing non-discrimination under section 401(k)(3) require such modification.

Restricting the withdrawal from qualified retirement plans of non-deductible employee contributions is inherently unfair and will have adverse effect on retirement savings by employees.

Major restructuring of the rules regarding VEBAs is inappropriate. The Joint Committee Staff Proposals limiting deductions and adding stringent new non-discrimination rules will be particularly adverse to small business and are not justified.

The imposition of uniform non-discrimination rules for all fringe benefits has been recently rejected by Congress and should not be adopted as part of the present legislation. These proposals will lead to substantial administrative complications without producing measurable improvements in the provisions of health coverage.

STATEMENT

On behalf of the Association for Advanced Life Underwriting (AALU) and the National Association of Life Underwriters (NALU), the following comments are submitted regarding the compensation-related provisions of the tax legislation currently under consideration by the Committee as part of its hearings on tax shelters, accounting abuses and corporate and securities reforms.

AALU is a nationwide organization of approximately 1,100 members specializing in one or more fields of advanced life underwriting. Collectively our members are responsible for annual sales of life insurance in excess of $2 billion, mostly in circumstances involving complex factual situations and often dealing with qualified retirement plans and similar employee compensation techniques. Much of the work performed by our members is with small businesses.

NALU, which has a membership of 1,022 state and local associations with combined individual membership of over 127,000 life insurance agents, general agents and managers, joins AALU in the submission of these comments.

We are alarmed at the manner in which major compensation legislation is here being developed. Although the Committee is providing a brief hearing on the merits of the issues, there has been inadequate notice, inadequate time in which to respond and inadequate information about the proposals being considered. Many taxpayers are still unaware of the nature of the compensation proposals that are before the Committee.

Congress is heading toward the enactment of legislation without a full consideratin of the views of the American taxpayer and American businessman on these proposals.

In the 1982 passage of TEFRA, major substantive tax legislation was enacted essentially without a hearing and without adequate notice to the public. Congress implemented, via a conference committee agreement, legislation that contained major changes in retirement policy. Following TEFRA, many congressmen and senators publicly avowed that this misuse of the legislative process would not occur again. Yet we have something very similar developing at the present time.

The three major defects in the current hearing are:

1. Inadequate Notice.—The Committee has provided inadequate notice regarding the compensation-related issued that are being considered. The description of the hearings, "Proposals Concerning Tax Shelters, Accounting Abuses and Corporate and Securities Reforms" gives essentially no information to the public that major compensation-related issues are being considered. Many businessmen are not yet aware of the contents of these proposals. Even the press has not picked up on the nature of many of the proposed changes.

2. Inadequate Time.—The first release that gave any substantive indication of the types of compensation-related issues that are before the Committee was the Joint Committee on Taxation's pamphlet of February 17, 1984.[1] The final date for submitting comments is February 28. If a businessman obtained the pamphlet on February 17, he had a maximum of 11 days to digest the information and prepare either testimony or a written submission for the Committee. In practical terms, only a few days at most were available between the time the information became readily available and the due dates for testifying and submitting comments.

3. Inadequate Information.—There is no bill to accompany the Joint Committee Staff Proposals. The Joint Committee Staff Proposals are lacking in vital information. For example, they suggest imposing a dollar limit on the employees who can be counted in the lower ⅔ group for purposes of section 401(k)(3) of the Code. The proposals do not, however, tell us what that dollar limit is, nor is there any official source from which to determine what it is. This type of result is repeated throughout the Joint Committee Staff Proposals.

The Committee should go forward with any of the compensation-related changes suggested in the Joint Committee Staff Proposals. Legislation should be enacted not in a vacuum, but only in he framework of a fair public opportunity to evaluate and comment. Our comments will necessarily be brief regarding the merits of these proposals because of the lack of time and information concerning them.

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[1] Proposal Relating to Tax Shelters and Other Tax-Motivated Transactions, Committee on Ways and Means, February 17, 1984 (hereinafter referred to as the "Joint Committee Staff Proposals").

1. Cafeteria plans.—Although we understand that the original intention was to include provisions in the Joint Committee Staff Proposals relating to cafeteria plans, no mention of cafeteria plans was made. There are, however, provisions in H.R. 4170 relating to cafeteria plans. Furthermore, we understand that this issue may be included in the legislation even though it is not formally a part of this hearing. Because of the likely speed with which the legislation may be enacted, we feel that it is necessary to comment on three aspects relating to cafeteria plans:

(a) the treatment of previously-established cafeteria plans;
(b) the availability of cash options in cafeteria plans; and
(c) the proposals contained in H.R. 4170.

The statutory provisions on cafeteria plans, section 125 of the Internal Revenue Code, were enacted as part of the Revenue Act of 1978 and became effective in 1979. In the five years since then, numerous corporations, both large and small, have adopted such plans based on a reasonable interpretation of the statute and its legislative history. The Treasury has not yet proposed regulations on the subject and only this year issued its first guidance on its interpretation of section 125. Each employer that wished to utilize cafeteria plans had no choice but to go forward with its own sense of a reasonable interpretation of the statute.

In I.R. 84-22, the Internal Revenue Service suggested that it intends to take a very restrictive reading of section 125. Under the policy there suggested, many cafeteria plans adopted by corporations will not qualify under the provisions of section 125. Leaving aside for the moment the merits of the Service's position in I.R. 85-22, it is clear that protection should be provided for all previously adopted cafeteria plans that do not violate the provisions of section 125. In short, cafeteria plans that allow employees to currently reduce salary to pay for medical benefits and that permit employees to receive any unused benefit allocations in cash should be protected. This protection should be provided for a period of time that will allow Congress to address the issue since it appears likely that the Service will interpret section 125 in a manner more restrictive than appears to be in the original Congressional intention.

The major objection to I.R. 84-22 is not its requirement that the employee must elect the benefit option in the year preceding the year in which the compensation is earned. Assistant Secretary Chapoton made it clear in the oral remarks before this Committee on February 22 that the Treasury Department agrees that salary reduction is a permissible method of providing benefits under section 125. Our principal objection to I.R. 84-22 is the requirement that the employee cannot receive any unused benefit allocations in cash. That is, if the employee does not use the benefits on a current basis, then any amounts available to that employee that are not used must be forfeited as of the close of the year.

This change in policy is not supported by the case law [2] and undermines the policy goals of cafeteria plans. Such plans are intended to promote efficiency in the provision of benefits to employees. Employees can select the benefits that are most suitable for their situation instead of being forced to take automatically-provided benefits. The proposed change would undermine this by making the employee assume the risk that all benefits will be fully utilized. This will make employees more reluctant to utilize cafeteria plans and consequently will constitute a move away from promoting efficiency in providing benefits to employees.

Further, eliminating cash options is not an appropriate course as a matter of revenue collection. Cash payments are taxable to the employees. Consequently, from a revenue point of view, they promote the payment, rather than the deferral, of taxes. The move away from permitting cash options should, therefore, not be pursued.

In the event, however, that the Committee formally supports the IRS position, the cash option should not be totally eliminated. Rather, an employee should be allowed to carryover any unused benefits into a following year. That is, the employee should not be forced to lose, at the end of each year, any credits available to him under a cafeteria plan. It should be made clear that these amounts may be paid into a cash or deferred profit sharing plan under section 401(k) of the Code without being lost.

Given the Internal Revenue Service's announcement in I.R. 84-22, it appears that legislation will be necessary to obtain these goals. The Committee should seriously consider enacting measures now that will prevent the IRS from undermining the development of cafeteria plans.

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[2] See, e.g., *Viet* v. *Commissioner,* 8 T.C. 809 (1947), acq. 1947-2 C.B. 4; *Commissioner* v. *Oates,* 207 F.2d 711 (7th Cir. 1953); *Commissioner* v. *Olmsted Incorporated Life Agency,* 304 F.2d 16 (8th Cir. 1962); *Veit* v. *Commissioner,* 8 T.C.M. 919 (1949).

The final cafeteria plan matter that requires immediate comment is H.R. 4170. The cafeteria plan provisions in that bill would prohibit the inclusion of any taxable benefits in cafeteria plans. Employees are required to pay income tax on any taxable benefits elected; consequently no purpose appears to be served by prohibiting their inclusion in a cafeteria plan. Yet prohibiting taxable benefits from being included in a cafeteria plan undermines the policy goals of promoting efficiency and providing an opportunity of cost saving to employees through mass purchasing of benefits. If a problem should develop with employees failing to report taxable benefits, then procedures could be developed to buttress the reporting requirements on employers for misreporting taxable benefits selected through a cafeteria plan. That is the appropriate solution to the problem—not the preclusion of taxable benefits altogether.

The other problem covered in H.R. 4170 is valuation. There is difficulty in valuing taxable benefits offered through a cafeteria plan and therefore there may be underreporting of income taxes as a result of low valuations.

This problem, of course, is not a new one for the internal Revenue Service. Properly valuating benefits is an issue of long duration. Eliminating their inclusion in cafeteria plans does not solve the problem. Benefits can still be provided to employees outside a cafeteria plan and the same valuation problems will be involved. Again, the solution is to impose requirements that ensure that the employer will properly report the benefit selected. Elimination of these benefits in cafeteria plans undermines other important policies without providing revenue enhancement or serving any clearly defined policy goal.

2. Cash or deferred profit sharing plans.—The Joint Committee Staff Proposals contain three major modifications in the rules under section 401(k) of the Code. First, an unspecified dollar limitation would be added to the rules in section 401(k)(3) to limit the lower paid employees that would be counted for purposes of testing the non-discriminatory operation of the plan. Second, the definition of "hardship" would be modified to restrict the incidence of hardship and to specifically eliminate the ability to have a hardship distribution to pay college expenses and purchase a home. Third, section 401(k) plans would not be allowed to qualify as being non-discriminatory under the general non-discrimination rules of section 401(a) but would instead be required to qualify under the special rules of section 401(k)(3).

The rules on cash or deferred arrangements were enacted as part of the Revenue Act of 1978 effective beginning in 1980. We do not yet even have final regulations under section 401(k).

We are particularly concerned that the rules under section 401(k) are being changed before there has even been an adequate opportunity to develop data on the experience resulting from the adoption of section 401(k) arrangements.

The effect of the proposals will be to limit and restrict the use of section 401(k) plans which have heretofore provided a highly important savings mechanism for employees, including rank-and-file employees. Restricting the ability to take hardship distributions will have a psychologically detrimental effect on the operation of the plans and will hinder the savings effort that has been fostered by these plans. This type of policy change is entirely undesirable.

Further, placing dollar limits on the lower paid employees that can be counted for purposes of the non-discrimination test under section 401(k)(3) is also not justified. There is no data that would support its inclusion. The Joint Committee Staff Proposal does not even specify the dollar limit that would be utilized and so it is difficult to respond to this proposal. Further, the proposal primarily discriminates against small business. Whatever dollar limit is proposed is likely to be designed to inhibit the use of section 401(k) by smaller businesses, especially high technology and professionally oriented businesses. It should be recognized that cash or deferred arrangements are typically not used by very small corporations, including professional corporations, but instead are utilized by medium and larger corporations. Therefore, to the extent that the proposal represents an anti-small business proposal along the lines of those included in TEFRA, it is misplaced. This proposal will be directed not at professionals, but at middle size corporations.

Finally, there appears to be no justification for not permitting section 401(k) plans to qualify under the general non-discrimination rules available to all qualified plans. If a plan is, in fact, non-discriminatory under the general rules applicable to profit sharing and pension plans, then it has clearly complied with the non-discrimination requirements imposed by Congress, whether or not it satisfies the safe harbor rules of section 401(k). The ability to utilize the general non-discrimination rules are particularly important for larger companies where there is a diversity in the operations of the business that may require separate plans for different classes of employees or other types of arrangements that may not lend themselves to falling within the special safe harbors of section 401(k)(3). Since these plans are by definition non-discriminatory because they have satisfied the same non-discrimination rules that a regular profit sharing plan would have to satisfy, there should not be any reason to prevent the plan from being a qualified plan.

3. Withdrawal of Employee Contributions.—The Joint Committee Staff Proposal would make two major changes in the tax rules concerning the withdrawal of nondeductible employee contributions to qualified plans. The first would change the ordering rule to require that earnings on those contributions be deemed to be distributed first, thereby making withdrawals partially or fully taxable and the second would impose a 10 percent excise tax penalty on any withdrawals before separation from service or age 59½.

This change would clearly undermine the promotion of retirement savings by employees, an important social goal recognized by Congress. Employees will be reluctant to "lock in" their personal savings if they feel that they are unable, in practical terms, to reach those monies in the event a need arises.

At a minimum, pre-existing, non-deductible employee contributions should be permanently grand-fathered so that these amounts can be withdrawn under the rules that existed at the time they were contributed. Otherwise, employees will be unfairly taxed on amounts that, when contributed were subject to withdrawal without taxation.

4. Voluntary employee beneficiary associations (VEBAs).—The Joint Committee Staff Proposals would substantially restrict the deduction available for VEBA contributions as well as impose new severe non-discrimination rules on VEBAs. The proposals would also eliminate or restrict certain types of benefits that have historically been provided by VEBAs.

The Internal Revenue Service has recently stopped approving certain types of VEBAs in which the benefits go primarily to owners. This effort by the Service should largely eliminate the "misuse" of VEBAs under existing rules. There has not been demonstrated any need for legislative rewriting of the rules under section 501(c)(9), especially in the radical fashion suggested by the Joint Committee Staff Proposals.

The proposed limitations on deductions for VEBA contributions would largely eliminate the ability to deduct those contributions when made, especially for smaller businesses. This is particularly harsh and inappropriate since the contributing corporation has clearly incurred the expense at the time the VEBA contribution is made. While it is true that corporations are not permitted deductions for the incurring of non-qualified deferred compensation arrangements obligations, those arrangements typically are not irrevocably funded and the types of benefits being provided are fundamentally different and are generally provided to a different class of employee. Non-qualified deferred compensation is typically provided mostly to highly compensated employees. VEBAs, on the other hand, provide welfare benefits, some of which will not be taxable and are provided under the non-discrimination rules of section 501(c)(9).

The only problem that would appear to justify any type of change in the deduction rules for VEBAs would possibly be the problem of VEBA overfunding. This problem, however, is appropriately solved through the development of actuarial funding criteria similar to those used for qualified plans. The Joint Committee Staff Proposal to establish a reserve, which is generally limited to 50 percent of the annual benefits paid over the last three years, may not, in a number of situations involving small employers, provide a fair representation of the amounts needed to properly fund the VEBAs.

The proposals to limit the amount of benefits available to officers, owners and highly compensated employees to 25 percent of the annual benefits provided is unnecessarily harsh and discriminates against small businesses. If the VEBA provides benefits in accordance with the non-discrimination rules of section 501(c)(9), the amount of annual benefit that happens to be drawn by the owner, officer or highly compensated group in any given year should not be material. The effect of such a proposal is to eliminate the ability of small business to utilize VEBAs but permit its continued utilization by large business. This policy change has not been justified by the Joint Committee staff, nor is there any evidence that would warrant a general prohibition against VEBA use by smaller business.

The Joint Committee Staff Proposals also would require that severance pay VEBAs be included in the computation under section 415. This is a radical change in the utilization of section 415 that has not been adequately justified. If severance pay benefits are provided primarily to owner-employees and others who are covered up to the section 415 limits under a qualified plan, the Internal Revenue Service policy of prohibiting the establishment of a section 501(c)(9) trust should be adequate to eliminate the use of severance pay VEBAs. Section 415 is designed as a limit of qualified retirement plans and should not be confused with welfare-type benefits that may be provided under section 501(c)(9).

6. Fringe benefit proposals.—The Joint Committee Staff Proposals would provide a definition of deferred compensation and would extend "uniform non-discrimination rules" to all fringe benefits receiving favorable tax treatment.

It is difficult to comment on these proposals without additional data. The Joint Committee Staff Proposals do not clarify what non-discrimination rule would be uniformly applied to all fringe benefits, nor do they specify the fringe benefits to which the non-discrimination standard would be applied. Further, the impact of the proposed definition of deferred compensation has not been clarified in any meaningful sense so that commenting on the effect of its application is extremely difficult.

Furthermore, that there has not been any justification for such a radical change, especially in the absence of a careful evaluation. The proposal to make the non-discrimination rules uniformly applicable to health and group-term life insuance was considered and largely rejected as part of the enactment of TEFRA. Raising this issue again, when it has just recently been rejected by Congress, is inappropriate in the absence of any special justification. During the enactment of TEFRA, numerous businesses pointed out that substantial problems would be created if uniform non-discrimination rules were applied to group health and group life insurance arrangements. The extensive problems documented by this Committee in considering the pre-TEFRA legislation should be recognized and proposals to enact this type of radical change without careful consideration should be rejected.

7. Affiliated service group rules.—The Joint Committee Staff Proposals, with alarming brevity, suggests an extension of the affiliated service group rules of section 414(m) to certain employee sharing and related party transactions. The staff proposals do not clarify what related party transactions are involved, nor how employee sharing arrangements would be treated. It is extremely difficult to comment usefully on such vague proposals.

With respect to employee sharing arrangements it should be noted that in many small businesses employees are shared as a cost saving mechanism, not as a technique for avoiding benefit coverage. In the past, the Internal Revenue Service has generally permitted a shared employee to be treated as a part-time employee of each separate business so long as the employee is treated as a full-time employee for purposes of qualifying for benefits under qualified retirement and other programs provided by each employer. To require that the employee be treated as a full-time employee for all purposes under each employer's plan could result in the requirement that the employee receive double benefit coverage from each employer. This would, in effect, amount to an employee windfall under which the employee would receive proportionately greater benefits than any of the other employees of the individual corporations.

CONCLUDING COMMENTS

AALU, together with NALU, strongly protest the manner in which the hearings on compensation-related issues are being held. In addition, the Joint Committee Staff Proposals would provide many radical changes without adequate justification or consideration. We therefore urge the Committee to reject adoption of these proposals as part of any revenue enhancement bill that will be enacted. If the proposals are deemed to warrant serious consideration, the Committee should schedule a hearing for the fuller consideration at a later time.

STATEMENT OF ALAN SHESTACK, PRESIDENT, ASSOCIATION OF ART MUSEUM DIRECTORS

I am pleased to present the following testimony as president of the Association of Art Museum Directors.

The AAMD is an organization consisting of the directors of America's 150 largest art museums. Our association is deeply concerned about discussions now underway in Congress regarding possible legislation affecting the tax benefits which accrue to donors of works of art to museums. There has been a great deal of press coverage during the last year, sensationalizing a few incidents involving grossly inflated appraisals, especially the Smithsonian gem scandal. Our association condemns this practice and the museums and individuals participating in it, and we share the public's concern that some have exploited the law by obtaining exaggerated tax deductions. At the same time, we wish to assert that these recently revealed incidents are not the tip of an iceberg, but are isolated events almost totally uncharacteristic of the usual "agenda" for giving art works to museums.

Indeed, I can testify that most donors (close to 100 each year) to my own museum, the Yale University Art Gallery, are scrupulous in obtaining reasonable and legitimate appraisals; some even intentionally undervalue their gifts to be absolutely certain they are not in violation. I fear that the recent publicity has led to a public misperception of the issue. There is, in fact, no evidence that the law has been widely abused.

You probably know that members of the museum profession serve without fee on the IRS Arts Advisory Panel which automatically reviews values on works of art for which the donor claims a deduction of $20,000 or more. On 1982 tax returns, values of works of art had to be adjusted downward by only a total of $5,000,000, a sum which represented only 11% of the total value claimed. Clearly, there are some abusers and, it must be admitted, art appraising is not an exact science, but these figures hardly indicate a widespread problem.

We must also remember that the excellence of America's art museum collections is due primarily to the tax incentive. Current tax law, which encourages the donation to museums of just those works of art which *have* appreciated in dollar value (that is, which the test of time and critical opinion have validated), is the single most important stimulus to the growth and improvement of American museum holdings. The cultural life of the United States has been vastly improved because of the tax law as it stands. In my own museum, over 75% of the works of art have come as gifts, and nationally, 90% of all objects in museums were donated, not purchased. It is absolutely essential to the future of America's art museums that the tax law continue to encourage the donation of works of art which are often far too expensive for most institutions to acquire by purchase.

I understand that a proposal is now before the Finance Committee which would require a donor to hold an object for three years before he or she could make a gift which qualifies for a full market value deduction. This, coupled with the proposed changes in the capital gains law, will encourage many to sell objects, pay the relatively low tax, and leave museums totally out of the transaction. If potential donors are required to hold property three times longer than would be necessary to achieve the same benefit under the capital gains requirements, museums and the public will be the losers. We urge that the holding period for donations be the same as that required for long-term capital gains.

At our association's midwinter meeting in January, over 100 Museum Directors discussed these issues. Opinion was unanimous that we, as a profession, would not condone abuses, would not cooperate with donors seeking excessive appraisals, and would do all in our power to ensure that objects given to art museums are fairly appraised. Our association would encourage the IRS to crack down on abuses of the system. In our opinion, strengthening the appraisal process particularly penalties for overevaluation would more effectively target tax abusers than the proposed holding period. Members of our association stand ready to advise and/or assist the Congress or the IRS in these matters.

American museums are the envy of the world. When European curators visit the United States, they are amazed by the stellar collections which have been assembled by museums in every major city from coast to coast. Most of these public collections were formed in this century, aided enormously by the tax incentive. It is universally understood that an enlightened tax law is responsible for the burgeoning of public museums in this country. Now, when the art market is shrinking, masterpieces are more scarce than ever, and museums find themselves financially pressed on all fronts, it would be an especially severe blow if the government removed or decreased the incentive for private donations. We trust these points will be considered before irreversible action is taken by the Congress.

STATEMENT OF DAVID G. GLICKMAN, ON BEHALF OF BELDEN & BLAKE OIL PRODUCTION, INC.

Mr. Chairman and members of the committee, my name is David G. Glickman. I practice law in Dallas, Texas with the firm of Johnson & Swanson. My firm represents Belden & Blake Oil Production, Inc., which is in the process of forming a limited partnership which will be publicly traded and have over one hundred limited partners, and historically has formed limited partnership drilling funds which are not publicly traded but have more than one hundred limited partners. In addition, we represent other limited partnerships which are either publicly traded and/or have over one hundred limited partners.

Our concern is directed to the proposals (which are referred to herein as the "Publicly Traded Partnership Proposal" and the "100 Partner Proposal," or simply as the "Proposal" or "Proposals," where the context makes the meaning clear) described in paragraph V.A.3., page 30, of the pamphlet prepared by the Joint Committee on Taxation entitled "Proposals Relating to Tax Shelters and Other Tax-Motivated Transactions" (the "Pamphlet"), which provides as follows:

"Publicly traded partnerships.—The Committee may wish to consider a proposal by Mr. Pease to limit the use of partnerships to create publicly tradeable tax losses by treating partnerships with more than 100 members as corporations. Alternatively, the Committee could consider a Senate Finance Committee Study proposal that publicly traded partnerships be treated as associations taxable as corporations. This treatment cold be applied only to partnership's interests in which are traded on an established securities exchange. [sic] The Treasury Department opposed this proposal in testifying before the Senate Finance Committee.

Although hearings on this issue were held on February 22 and 28, 1984, it is understood that a written statement regarding the Proposals would be accepted no later than March 6, 1984. Accordingly, on behalf of our client, I am submitting this written statement for consideration by the Committee on Ways and Means (the "Committee").

GENERAL OBSERVATION

The first part of this written statement will be directed to the suggestion of the Pamphlet that publicly traded limited partnerships be treated as associations taxable as corporations. The Pamphlet notes that the Publicly Traded Partnership Proposal was considered by a report of the Staff of the Senate Finance Committee entitled "The Reform and Simplification of the Income Taxation of Corporations." I submitted a written statement to the Senate Finance Committee with respect to the Publicly Traded Partnership Proposal on November 2, 1983. The first portion of this written statement is virtually identical to the written statement so presented to the Senate Finance Committee, and is directed principally to the question of whether a publicly traded limited partnership more nearly resembles a corporation than a partnership. The analysis therein is equally applicable to the question of whether a partnership with more than 100 members more nearly resembles a corporation than a partnership.

The second portion of this written statement is directed to the suggestion that partnerships with more than one hundred members be treated as corporations. The discussion therein addresses the fundamental question of whether problems in the tax shelter arena are appropriately addressed by reclassifying partnerships on the basis solely of the number of partners involved.

THE PUBLICLY TRADED PARTNERSHIP PROPOSAL

I. Arguments advanced in support of the proposal

Two arguments have most often been advanced in favor of this Proposal: (i) "publicly traded limited partnerships are simply too similar to business entities that are taxed as associations," and (ii) the partnership tax rules cannot work effectively for publicly traded limited partnerships. Apparently, this latter concern relates to compliance with the Federal income tax laws by publicly held limited partnerships and their partners. In addition, since there has been significant public discussion of the issue whether public trading of limited partnership interests will lead to the conversion of large numbers of corporations into partnerships (see Mack, *Disincorporating America,* Forbes (August 1, 1983) at 76) (the "Forbes Article"), it appears that proponents of the Proposal may be concerned that the continued treatment of publicly traded limited partnerships as partnerships for Federal tax purposes will lead to the "disincorporation of America" and a substantial loss of revenues. My comments will be directed primarily to the substantive issue of whether publicly traded limited partnerships are, in fact, "too similar" to business entities taxable as corporations, and to the practical and policy implications of the Proposal.

II. Summary of comments

The Proposal should be rejected for the following reasons:

(i) Given the myriad of traits that may affect the classification of a business organization for Federal tax purposes, the classification of business entities should remain with the courts and the Executive Branch in accordance with well-conceived standards of universal application and should not be undertaken by Congress on a case-by-case basis.

(ii) Public trading of interests is an extrinsic characteristic of organizations that has nothing to do with the relationship of the members to each other or of the members to the organization. A partnership is no less a partnership because its interests are bought and sold, just as a public company is no less a corporation when its stock ceases to be traded. Therefore, public trading of interests is not a distinguishing corporate characteristic and should be irrelevant to the determination of whether a business entity constitutes an association taxable as a corporation.

(iii) If there is concern with the methodology by which the existing classification regulations draw the line between "true" partnerships and associations, then a careful and thorough study of the standards is required. If anything, new standards of universal application, not expedited legislation that is targeted to a narrow cross-section of business entities, should result from this study.

(iv) Compliance with the Federal income tax laws applicable to partnerships and partners has been greatly facilitated by the enactment of the partnership audit and procedural rules of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), coupled with the use of sophisticated accounting software developed by publicly traded limited partnerships. Accordingly, I believe that the Department of the Treasury ("Treasury"), in its testimony before the Senate Finance Committee, was accurate in stating, "[t]hese . . . problems are faced to a greater or lesser degree by every partnership and we are not convinced that [they] are insuperable." (Hearing on Preliminary Report on the Reform and Simplification of the Income Taxation of Corporations, held October 24, 1983.)

(v) Finally, in light of the operational differences between corporations and partnerships and the tax and other costs that would be incurred in converting a corporation into a partnership, it is difficult to see how a loss of revenues will result from the continued classification of publicly traded limited partnerships as partnerships for Federal tax purposes.

III. The definition of "association"

Superficially, the Proposal appears to be a manifestation of a bias in favor of the two-tiered taxing structure of Subchapter C of the Code [1] over the integrated taxing structure of Subchapter K of the Code. Upon closer examination, however, it is apparent from the restricted scope of the Proposal that it is not founded on such a general premise, but rather is based primarily upon the proposition that public trading of interests is a corporate characteristic that should, regardless of the presence or absence of other corporate traits, result in the classification of a limited partnership as an association taxable as a corporation. As discussed hereinafter, it is ill-advised, as a matter of legislative policy, to attempt to classify organizations by ad hoc legislation rather than to permit the courts and Executive Branch to make such determinations in accordance with a rational methodology of universal application. Furthermore, it is submitted that public trading of interests is not a corporate characteristic that should be considered in determining the classification of an organization.

A. Congress should not attempt to classify business organizations on a case-by-case basis

Since the Income Tax Act of 1894 (28 Stat. 556), the Code and its predecessors have afforded taxpayers a choice between taxable entities (namely, corporations and "associations") and "conduit" entities (namely, general and limited partnerships), and has left the task of defining or classifying such entities to the courts and the Executive Branch. See, I *Seidman's Legislative History of Federal Income Tax Laws* 1020, 21 (1938); *Flint* v. *Stone Tracy Co.,* 220 U.S. 107 (1911). By delegating the task of defining associations to the courts, Treasury, and the Internal Revenue Service (the "Service"), it appears that Congress concluded, as the Supreme Court later stated, that "[i]t is impossible in the nature of things to translate the statutory concept of 'association' into a particularity of detail that would fix the status of every sort of enterprise or organization which ingenuity may create . . . ." *Morrissey* v. *Commissioner,* 296 U.S. 344, 350 (1935).

Presently, the Committee is addressing the propriety of classifying a narrowly restricted group of limited partnerships as "true" partnerships rather than as associations taxable as corporations. At some future time, perhaps some other particular business organization will be questioned. In essence, the question is not merely whether publicly traded limited partnerships should be taxed as corporations; rather, the question also involves the broader policy consideration of whether it is advisable for Congress to determine, on a case-by-case basis, the Federal tax classification of a specific business organization, or whether such determinations are better left to the courts and the Executive Branch based upon logical distinctions formulated in an orderly fashion over time.

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[1] Unless otherwise stated, the term "Code" means, and all section references are to, the Internal Revenue Code of 1954, as amended.

Given the variety of traits that a business organization may possess and the administrative inefficiency that would result if it is left to Congress to determine the Federal tax classification of specific organizations on a case-by-case basis, Congress should not embark upon this path.

B. A limited partnership does not more nearly resemble a corporation than a "true" partnership merely because its interests are publicly traded

Any decision made by the Committee with respect to the Proposal should be based upon a well conceived, rational methodology for classifying entities and not upon a vague feeling or belief that a publicly traded limited partnership "walks and talks like a corporation." See the Forbes Article. It is submitted that the first step in applying a rational means of determining the Federal tax classification of a specific form of enterprise is to ascertain whether the organization possesses traits that are intrinsic to *de jure* corporations.

In *Morrissey* v. *Commissioner, supra,* the Supreme Court, addressing the question of whether a trust should be classified as an association, first identified the characteristics that, in its view, should be considered in determining whether an organization is an association. Although the corporate characteristics enumerated by the court in *Morrissey* may not be exhaustive of the traits shared by all *de jure* corporations, such characteristics are certainly significant corporate traits that should be taken into account. According to the Court in *Morrissey,* a *sine qua non* of association status is that the organization be comprised of "associates" who have joined together to conduct an enterprise for profit. Other factors considered by the Court were:

(i) the limitation of liability for the debts of the organization to the property of the organization, with no recourse to the properties of its beneficial owners;

(ii) the ability to transfer beneficial interests in the organization without destroying the continuity of the enterprise, and the opportunity for continuation of the enterprise without interruption by the death of a beneficial owner; [2] and

(iii) the opportunity for centralization of management in representatives (who need not be owners of beneficial interests in the organization).

In 1960, primarily in response to the taxpayer's victory in *United States* v. *Kintner,* 216 F.2d 418 (9th Cir. 1954), Treasury promulgated the current regulations under section 7701 of the Code governing the determination of whether an organization should be classified as a trust, a partnership, or an association for Federal tax purposes. See Treas. Reg. § 301.7701-2. These regulations adopt and refine the criteria set forth in the *Morrissey* case. In general, the regulations provide that an organization will be taxed as a corporation for Federal tax purposes if (i) the organization is comprised of associates who have an objective to carry on a business or financial enterprise and divide the gains therefrom, and (ii) the organization possesses at least three of the following characteristics: (a) continuity of life, (b) centralization of management, (c) limited liability, and (d) free transferability of interests. Treas. Regs. §§ 301.7701-2(a)(1) and 301.7701-2(a)(3). Since the promulgation of these regulations, the courts have generally followed the classification scheme adopted by Treasury. See *Zuckman* v. *United States,* 524 F.2d 729 (Ct. Cl. 1975); *Phillip G. Larson,* 66 T.C. 159 (1976); cf. *Outlaw* v. *United States,* 494 F.2d 1376 (Ct. Cl. 1974).

Clearly, publicly traded limited partnerships (just as privately held limited partnerships) are composed of "associates" who have an objective of carrying on a financial enterprise and dividing the gains therefrom. However, such publicly traded limited partnerships (as is the case with most privately held limited partnerships) have been carefully structured such that they lack at least two of the corporate characteristics of continuity of life, centralization of management, limited liability, and free transferability of interests; as such, these limited partnerships are not classified as associations taxable as corporations under the current regulatory application of the *Morrissey* test.

Since the Proposal would classify a publicly traded limited partnership as an association taxable as a corporation even though it is identical in all other respects to a privately held (or, for that matter, publicly held but not traded) limited partnership that will continue to be classified as a partnership, it appears that the proponents of the Proposal must believe either that public trading of interests, *per se*, is a controlling corporate trait, or that public trading of interests results in, or is symptomatic of, the existence of a controlling corporate trait. Public trading of interests, *per se*, may be viewed as a controlling factor for classification purposes only if it is a trait intrinsic to corporations. While it is true that the overwhelming majority of interests traded on our securities markets are stock and debt securities of corporations, it is also true that the overwhelming majority of corporations are privately owned corporations whose stock is at least as illiquid as interests in their closely held partnership counterparts. In addition, there are numerous privately owned partnerships and corporations whose interests are highly liquid by reason of puts, redemption provisions, and market clearing arrangements (which do not constitute "established securities markets" under any definition of the term). Liquidity or ready marketability of interests is in fact dependent upon circumstances that are extrinsic to the relationship of the members to the organization or of the members to each other. Accordingly, public trading of interests, *per se*, simply is not a trait that is intrinsic to corporations, hence should be irrelevant to the determination of whether a business organization should be classified as an association taxable as a corporation.

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[2] It should be noted that the Court in *Morrissey* seems to have viewed "free transferability of interests" and "continuity of life" as a single, inseparable corporate trait. As discussed below, subsequent courts viewed these as two distinct characteristics.

Notwithstanding the foregoing, the Proposal might be logically supportable if it were grounded on the proposition that public trading of interests results in, or is symptomatic of, an intrinsic corporate trait that should be afforded controlling significance for classification purposes. The only intrinsic corporate trait that appears to bear any resemblance or relation to public trading of interests is the trait of free transferability of interests.

In *Morrissey*, the power (or legal right) to transfer an interest without ending the existence of the organization was held to be a corporate characteristics, Subsequently, the courts refined this concept and held that free transferability of interests is a separate trait that exists if the transferee of an interest in the organization is substituted to all rights and powers of the transferor vis-a-vis the organization. See *Glensder Textile Co.*, 46 B.T.A. 176 (1942). It is submitted that this trait of "free transferability of interests" is common to all *de jure* corporations, hence is a proper criterion to consider in determining whether an organization should be classified as an association taxable as a corporation.

Most (if not all) publicly traded limited partnerships possess the *Morrissey-Glensder Textile* trait of free transferability of interests, as reiterated in Treas. Reg. § 301.7701-2(e). However, there are also many non-traded limited partnerships possessing the trait of "free transferability" which would not be classified as associations under the Proposal. It is therefore clear that the trait of "free transferability" is not dependent, in whole or in part, upon the public trading of interests, and that the Proposal cannot be based upon the theory that such "free transferability" is a corporate characteristic that, in the case of limited partnerships, should be controlling for classification purposes.

It is possible that the concern with public trading of interests reflects an underlying discomfort with the size of publicly traded limited partnerships or the similarity of their interests to stock. Although the label of corporation is commonly associated with the concept of large enterprises (or "big business"), it is submitted that size (whether measured in terms of asset values or number of participants) should not be a relevant consideration for purposes of determining the Federal tax classification of an organization. If two or more individuals wish to pool their assets in the conduct of a business, they should have the right to choose between the provisions of Subchapter K and those of Subchapter C, regardless of the value of those assets. Similarly, the number of participants in an enterprise is not an intrinsic corporate trait, hence should not be relevant to the determination of the Federal tax status of an organization. A one-shareholder corporation is no less a corporation than a publicly held corporation. In any event, the Proposal, by its terms, is not targeted to all "large" partnerships, since it would not revoke the partnership status of large, publicly held (but not traded) limited partnerships.

Insofar as the similarity of limited partnership interests and stock is concerned, there is no doubt that limited partners and stockholders have similar rights and obligations. Indeed, in 1822, the first limited partnership act ws enacted expressly to permit "silent" partners to contribute capital to a partnership while having a position analogous to that of a stockholder. See, generally, 60 *Am Jur 2d* at p. 253. However, since the similarity exists regardless of the numbers of limited partners and stockholders or the existence of an established market for interests, it is not a reason to distinguish between publicly traded and other limited partnerships and, accordingly, cannot be an argument supportive of the Proposal.

To summarize, the only significant difference between publicly traded limited partnerships (which admittedly possess the intrinsic corporate trait of "free transferability" of interests) and many other limited partnerships (which, although not publicly traded, also posses the trait of "free transferability" of interests) is the existence of an established market for interests. Since the existence of an established market for interests is not a distinguishing characteristic of corporations, it would be unjustifiable for Congress to eanct legislation that will draw an artificial and irrational distinction between publicly traded limited partnerships and functionally identical limited partnerships whose interests are not traded.

C. Revision or replacement of existing standards

The Proposal may stem partially from concern with the line currently drawn by the regulations under section 7701 between "true" partnerships and associations taxable as corporations. It might be argued that the existing regulations under section 701 manifest an overreaction to the *Kintner* decision and do not apply a sound methodology for determining association status. However, even assuming, *arguendo* that the existing regulations under section 7701 are not sound, it would not be an appropriate reaction for Congress to enact legislation that arbitrarily draws the line based upon trading of interests; rather, Congress or Treasury would be better advised to consider the adoption of new standards having universal application, or the revision of existing standards. In so doing, Congress or Treasury must be aware that it will be disrupting a balance between "conduit" business entities and taxable business entities that has been in existance since 1960. Such disruption requires careful and thorough deliberation of problems and policies far more extensive than those considered by the proponents of the Proposal, and is not a matter for expedited legislation.[3]

IV. Operation of partnership tax rules

The second agrument advanced in favor of the Proposal is that the partnership tax rules cannot work effectively for publicly traded limited partnerships. The administrative problems typically associated with publicly traded limited partnerships are principally the difficulty in allocating various tax items among numerous partners where there are multiple transfers of interests during the taxable year and the possibility for tax avoidance where interests are held in street name.

It is my understanding that both the allocation and street name problems have been substantially reduced by the TEFRA partnership audit rules and by the use of sophisticated accounting programs that have been developed by publicly traded limited partnerships. In addition, the reporting requirements imposed upon publicly traded limited partnerships and the public scrutiny that these partnerships receive would seem to make them less likely to engage in tax avoidance activities than partnerships which are not publicly traded. Accordingly, I believe that Treasury, in its testimony before the Senate Finance Committee referred to previously, was accurate in stating "[t]hese . . . problems are faced to a greater or lesser degree by every partnership and we are not convinced that [they] are insuperable."

V. The impediments to "disincorporating" America

Concern, stemming principally from the Forbes Article, has been expressed that, if publicly traded limited partnerships continue to be classified as partnerships for Federal tax purposes, soon many large corporations will be "disincorporated" into publicly traded limited partnerships, resulting in a substantial loss of revenues. For the following reasons, it is difficult to see how a significant loss of revenues will result from the continued classification of publicly traded limited partnerships as partnerships for Federal tax purposes.

A. Tax and financial impediments to "disincorporation"

There appear to be only three generic methods (albeit, with many variations) by which a large corporation may be "disincorporated," within the meaning of the Forbes Article. One method would be for the corporation to completely liquidate and transfer its assets to a newly created or existing limited partnership. For most profitable corporations, the tax costs (in the form of capital gain tax at the shareholder level and recapture tax at the corporate level) of a complete liquidation would be substantial, if not prohibitive.[4] Of course, for a few corporations that have incurred substantial economic losses and that possess significant net operating loss carryovers and other tax benefits, such a complete liquidation might be implemented without significant tax costs at the corporate or shareholder level. However, such loss companies comprise only a small portion of the universe of publicly traded corporations. Also, since such a complete liquidation of a loss corporation would result in the elimination of its tax benefits, there is a strong tax disincentive for completely liquidating. Thus, it seems highly unlikely that many large corporations would be completely liquidated into publicly traded limited partnerships.

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[3] As Treasury and others have pointed out to this Committee, the use of limited partnerships taxable under Subchapter K of the Code is very important (if not critical) to the flow of capital into the natural resource exploration research and develpment, and housing development industries. Any revisions of the association standards that might reduce the flow of capital into these industries must be scrutinized thoroughly. Other problems and policy considerations include (i) whether it is advisable to broaden, narrow, or eliminate the two-tiered tax regime of Subchapter C and (ii) the tension that will be placed upon the classification issue if the Subchapter C proposals recommended in the Report are enacted.

Perhaps another method for "disincorporating" a corporation would be for the corporation to contribute all or a portion of its business to a limited partnership and raise capital for that business by selling limited partnership units to the public. Since a portion of the operating revenues of the partnership would be diverted from the corporation to the new partners, there is clearly a financial disincentive for raising capital by selling partnership units to the public. It is submitted that, absent significant dilution of their existing shareholders, most corporations normally would prefer to raise capital by issuing new stock and thereby retain the operating revenues generated by the new capital. Furthermore, such conversion of an existing corporation into a partnership is not really a "disincorporation" of existing corporate earnings, since only the earnings attributable to the new capital contributed by the limited partners would be taxed to the new partners.

The third method for "disincorporating" a corporation would be for the corporation to contribute a portion of its assets to a limited partnership and then distribute limited partnership interests to its shareholders as a dividend or in redemption of stock. After TEFRA, any such distribution of limited partnership interests which results in capital gain to the distributee shareholders generally will result in corporate level tax under section 311(d)(1) of the Code, subject to certain very narrow exceptions. If this corporate level tax is not incurred by reason of the distribution, then the distribution generally will result in dividend income to the shareholders to the extent of the distributing corporation's earnings and profits. Thus, as in the case of the complete liquidation of a corporation, this method of piecemeal conversion into a partnership in most cases would result in substantial tax burdens at the shareholder and/or corporate levels.

Finally, if certain other proposals being considered by Congress, having to do with the recognition of gain at the corporate level in connection with corporate distributions, are enacted by Congress, then the tax disincentives for converting an existing corporation into a partnership will be even greater. There would then be no means of avoiding corporate level tax upon distributions of assets or partnership interests.

B. Operational impediments to disincorporation

In addition to the tax and financial impediments to "disincorporating," there are at least two significant operational distinctions between a limited partnership and a *de jure* corporation which, in theory and in practice, provide disincentives to conducting many businesses in limited partnership form. These disincentives will limit the conversion of existing corporations into limited partnerships and, in addition, will often cause a founder of a business to conduct the business in corporate, rather than limited partnership, solution.

The first significant operational distinction between a limited partnership and a *de jure* corporation is that, under virtually all state laws, a limited partnership must have a limited term of existence, whereas a corporation may exist perpetually. Limited partnerships always have a specified termination date and are terminated earlier upon the bankruptcy, liquidation or death of the general partners. The stated term of existence is often 50 years. It is possible that this term could be extended as the termination date draws near. In addition, the partnership agreements of most publicly traded limited partnerships have provided for multiple or substitute general partners, or other makeshift solutions, so as to continue business after the bankruptcy, liquidation or death of a general partner. In both cases, however, limited partner approval of the continuation of the partnership is ultimately required, and it is quite possible the limited partners would not elect to continue the partnership. In the corporate context, shareholder approval is required to terminate; in the limited partnership context, limited partner approval is required to continue to in existence. This distinction affords a corporation significantly greater assurance of continuation than is afforded to a limited partnership.

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[4] Theoretically, a complete liquidation under section 333 of the Code might be employed to avoid substantial Federal income tax at the shareholder level. However, for a variety of reasons, this alternative is not a practical maeans of "disincorporating" for most large corporations whose stocks are publicly traded.

The implications of a limited, and uncertain, term of existence will have their strongest effect as the termination date draws near. Since most limited partnerships have had limited business purposes, and publicly traded limited partnerships are relatively young, examples of difficulty doing business in the face of imminent termination are limited. The person considering conducting business in limited partnership or corporate form must nevertheless deal with the implications of a limited term of existence, particularly if the limited partners' interests are to be publicly traded. As the termination date approaches—even 10 or more years before termination—the business may be expected to encounter difficulties raising additional capital and taking advantage of opportunities which require long-term commitments. Throughout the term, the limited partnership will be more likely to hold assets which are readily saleable so that values recognized in liquidation would be less uncertain.

The difficulties resulting from a limited term of existence may not appear great. However, as a practical matter, all but the most shortsighted persons will be influenced by this limited partnership trait. Certain activities may well be conducted despite the limited term of existence. Ownership of producing oil wells and real estate, for instance, do not usually require periodic infusions of additional capital and the assets owned may be liquidated with relative ease and certainty. Other activities, however, could be severely handicapped, particularly if they can be expected, as is the case with most industrial organizations, to require substantial capital to replace or upgrade facilities or are required to enter into long term projects in order to provide for future growth.

The second significant operational distinction between a limited partnership and a *de jure* corporation is that the general partners of a limited partnership are liable for all obligations of the limited partnership, whereas management and owners of a corporation are not individually liable for corporate obligations. Thus, in order to conduct any business in limited partnership solution, the general partners (whether corporations or individuals) must be willing to assume unlimited liability in the event of failure. This difference is profound, and will further limit the desirability of doing business in limited partnership form. This is particularly true for ventures which require high levels of idebtedness and/or face uncertain futures.[5] It is not mere coincidence that limited partnerships have primarily engaged in limited purpose businesses where the risk of failure is confined to loss of the partners' contributions. Although publicly traded limited partnerships may have broader business purposes, to date every publicly traded limited partnership commenced its business with a substantial base of revenue generating assets and (subject to the single exception of real estate ventures which typically employ high levels of well-secured debt) a relatively low debt level. In conducting their businesses, publicly traded limited partnerships have as a rule restricted their operations to those which could be financed primarily from current cash flow.

It is submitted that these two distinctions between corporations and limited partnerships limited life and unlimited liability of the general partners—are, in fact as well as in theory, crucial and important differences. Indeed, perpetual life and limited liability are *the* two reasons corporations came into being and have become the preferred method of conducting business. For very real reasons, it is submitted that the role of the limited partnership is likely to remain limited primarily to those types of business that have limited goals and identifiable (and containable) business risks.

PARTNERSHIPS HAVING OVER 100 MEMBERS

As an alternative to the Publicly Traded Partnership Proposal, the Pamphlet suggests that consideration be given to the 100 Partner Proposal. The 100 Parther Proposal apparently is motivated by a concern over the pass-through of tax shelter losses by "large" partnerships. For the reasons submitted hereinafter, the 100 Partner Proposal is unresponsive to the perceived problems which are the subject matter of these hearings, and should be rejected.

First, the 100 Partner Proposal is purely arbitrary and will not accurately target is purported objective—pass-through of tax shelter losses. Experience indicates that a significant volumed of tax shelter losses are passed through partnerships having 100 partners or less. If the 100 Partner Proposal is adopted, there is no question that this volume will increase dramatically. In other words, the industries involved will certainly attempt to fit within whatever numerical guidelines are set. This will be true whethert the number is more than 100, more than 75 or more than 50. Ultimately, the principal beneficiaries will be those individuals who are well-advised and well-heeled and, thus, have the financial wherewithal to comply with the requirements.

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[5] Even corporations embarking on or purchasing speculative or highly leveraged businesses will wish to further limit their exposure by conducting the business through corporate subsidiaries.

Second, partnerships have been one of the principal sources of capital in many industries and represents a widely used vehicle in legitimate business transactions which have no tax shelter motivations. (See Footnote 3). Thus enactment of the Proposal could result in the proverbial "throwing out the baby with the bath water."

Third, the type of entities that would be impacted by the 100 Partner Proposal generally are not the ones which raise (or should raise) the principal concern in this area—namely the abusive tax shelter.[6] The state and Federal scrutiny of large partnerships under the securities laws is substantial, and any potential abuse will give rise to significant disclosure and compliance problems.

If the objectives of this Committee are to attack abusive tax shelters, it is submitted that it would be much better advised to target its attention to the real problem area. In other words, to use a "rapier rather than an axe" would best accomplish the desired results while at the same time not affect one of the basic pass-through entities which has been available for many, many years.

Finally, as stated previously, to the extent that the 100 Partner Proposal is viewed as a substitute for the Publicly Traded Partnership Proposal (in that it would certainly eliminate publicly traded limited partnerships), it is subject to the same criticisms enumerated previously in this testimony. Indeed, the underlying theory supporting the Publicly Traded Partnership Proposal appears to be the perceived corporate resemblance, and the existence of 101 partners, as opposed to 100, has no more to do with corporate resemblance than does public trading. In fact, the number of partners has never been an element used in determining classification. As emphasized previously, classification should be determined according to the legal relationship of the members of an organization to each other, and of the organization to its members.

CONCLUSION

For the reasons discussed above, the Publicly Traded Partnership Proposal and 100 Partner Proposal should be rejected. If the Committee is concerned that the current classification regulations may not properly draw the line between "true" partnerships and associations taxable as corporations, then a project should be initiated to study the problems and make recommendations targeted to the improvement of existing standards (if they are found lacking) or development of new standards having universal application. In the case of the 100 Partner Proposal, enactment would result in overkill to the extent that it applied to entities engaged in activities generating deductions and losses that are clearly sanctioned by Congress. Moreover, enactment would not efficiently attack the problem of abusive tax shelters to which the 100 Partner Proposal is presumably addressed.

STATEMENT OF GARDNER S. MCBRIDE, EXECUTIVE VICE PRESIDENT, BUILDING OWNERS AND MANAGERS ASSOCIATION INTERNATIONAL

SUMMARY

The Building Owners and Managers Association (BOMA) understands that there may be problems involving the use of the current partnership, corporate, and accounting rules and that there is concern about purely tax-motivated transactions. BOMA generally agrees that real problems in these areas should be addressed. BOMA supports reasonable efforts to remedy some of the problems regarding the use of limited partnerships and accounting rules. Accordingly, BOMA would not oppose a number of the proposals advanced by the Administration regarding tax law and accounting rule changes for partnerships and corporations, if these proposals are modified or drafted so as not to interfere with legitimate, non-tax motivated transactions.

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[6] The phrase "tax shelter" has become generic in nature, and may apply to economically motivated transactions and transactions which are designed to carry out Congress' stated intent in allowing certain types of deductions (such as intangible drilling and development costs, research and development costs, etc.). If Congress deems these benefits undesirable or unnecessary, it would presumably attack them directly.

In our detailed comments on these proposals, we indicate how we believe the Committee should modify the Administration proposals. These modifications are necessary to insure that in accomplishing the justified objectives of these proposals, adverse effects on legitimate business practices and on capital formation in the shopping center industry are minimized.

STATEMENT

I. Introduction

I am Gardner McBride, the executive director of the Building Owners and Managers Association International (BOMA). BOMA is an association of over 5,000 owners and managers of commercial office buildings comprising nearly one billion square feet of space. In addition, our members own or manage residential rental property as well as other types of nonresidential real estate.

A. Office building industry profile

It has been estimated that in 1982 there were 650,000 office buildings with 8.84 billion square feet of office space. An estimated 5.3 million persons were employed by these buildings in management, maintenance, custodial, and other positions. This amounted to 5 percent of total U.S. employment. Estimated 1982 office building employee payroll was $10.2 billion, with an additional $11.9 billion of economic activity generated through contract building services and another $3 billion of other building expenditures. This economic activity constituted .8 percent of total U.S. GNP.

The value of new office buildings put in place in 1982 was $23 billion—.7 percent of total U.S. GNP. It has been estimated that this construction provided 460,000 full-time jobs.

In addition to the direct contributions of the office building industry to the GNP and to employment, the industry provides an essential service to the entire economy—space for its managers and other white collar employees to work. An estimated 38.4 million persons were working in office buildings in 1982. This was 38 percent of the total U.S. workforce and 72 percent of the white collar workforce.

Office buildings are productive assets and increased investment in such assets promotes ecomomic growth. Office buildings incorporating technological advancements in insulation, environmental control, lighting, communications, security and other technologies can provide more effective and efficient work environments and increase energy efficiency.

B. Interdependence of the real estate industry

The various sectors of the real estate industry are strongly interrelated. The development and location of housing and job-related real estate such as office buildings, retail stores, and industrial facilities continually interact with one another.

C. Small business development

The real estate industry is composed almost totally of small firms. Sixty percent of all construction firms and eighty percent of all real estate service firms have four or fewer employees. It is well established that the vast majority of all new jobs are created by small businesses such as these.

Unfortunately, the small business nature of the industry makes it unusually susceptible to changes in enconomic conditions, financial climate, the tax code and other public policies. During the past, those factors have combined to retard the growth rate of all areas of real estate.

It is important that the consequences of future tax policy changes on this important industry be carefully considered.

II. Proposals affecting office buildings

A. Sources of proposals

Several proposals which may be considered by the Committee would adversely affect investment in real property, including office buildings. Some proposals would change the tax laws or accounting rules for partnerships or corporations investing in real estate. Other proposals would extend the ACRS recovery period for all structures, for used structures, or for non-owner occupied structures from 15 to 20 years. These proposals have been made by the Administration, Senator Dole, and others, and have been discussed in the Joint Committee on Taxation (JCT) staff pamphlet prepared for these hearings.

B. General comments

1. Needed investment in structures.—In meeting its concerns about perceived abuses, the Committee should be careful not to affect adversely capital formation in the real estate industry. Prior to the enactment of the Economic Recovery Tax Act of 1981 (ERTA), there had been a long term insufficiency in real property investment. ERTA provided some incentives for such investment. However, the Congressional Research Service has stated that the present law is still biased against investments in structures. Any change in the tax law which would increase the effective tax rate on income from investments in structures would increase this bias, result in further misallocation of investment capital, and increase the resulting economic loss.

2. Appropriate use of limited partnerships.—Commercial real estate ownership, such as office buildings, generally involve resources far beyond those of an individual. For this reason, virtually all investments in such property is accomplished through partnerships or corporations. Limited partnerships are one of the preferred forms of ownership of real property because their business, legal and tax attributes are well matched to the characteristics of real estate investment.

In a typical real estate limited partnership, the investment is managed by a general partner that is a substantial, experienced organization which bears the liability for the enterprise. The general partner has authority to manage the investment. The investment capital is primarily contributed by a number of individuals who are shielded from liability in excess of their investment. The limited partnership mechanism makes available investments in large real estate projects to middle income persons by permitting a relatively modest minimum investment and shielding their liability beyond that investment while providing them with the right to inspect the partnership's books to protect their investment.

Another important characteristic of partnerships is that they permit the effective use of tax benefits by investors, and, thus, effectuate tax policies intended to encourage investment. By permitting deductions from the operation of real estate to pass through the partnership to the investors, tax policies intended to attract investment capital into real estate are made effective.

The members of BOMA invest in and manage office buildings, assets with real economic substance and substantial economic and social benefits to their communities. Investments in office buildings often are made through limited partnerships.

BOMA supports reasonable efforts to remedy some of the problems regarding the use of limited partnerships and accounting rules.

However, Congress should be cautious in enacting such legislation in order to assure that legitimate and economically important uses of limited partnerships will not be impaired by measures intended to stop non-economic, tax-motivated transactions.

In this regard, we are concerned with the tone and some of the substance of some of the criticism and proposals in this area. Some of the analysis reflects a purely theoretical, overly simplistic view of the business practices that would be affected by the proposals. It often ignores the impact of the proposals on legitimate, non-tax motivated transactions. For this reason, some of the proposals go far beyond the perceived problem and would have far reaching, economically adverse effects not considered or discussed by those who propose them.

3. Partnership and corporation changes.—BOMA would not oppose a number of the Administration's proposals regarding tax law and accounting rule changes for partnerships and corporations, if these proposals were modified and drafted so as not to interfere with legitimate business transactions. We understand that there may be problems in the use of some of these provisions, and agree that the Committee should deal specifically with these problems.

In our detailed comments, we indicate how we believe the Committee should modify the Administration proposals so that they accomplish their goals without having an adverse effect on legitimate business practices.

However, some of the proposals would create severe problems for many non-tax motivated business transactions. These proposals would discourage or deter many projects with substantial economic and social benefits. We oppose such proposals, including the proposal to tax phantom income in deferred interest transactions and the proposal to prohibit tax-free like-kind exchanges of general partnership interests.

4. Changes in ACRS.—BOMA and the real estate and retail industries strongly oppose any change in the ACRS recovery period for structures. In a recent letter, 17 organizations representing broad segments of the residential, commercial, recreational, and industrial real estate industries and the retail sales industry urged the members of the Senate Finance Committee to oppose any proposal to extend the cost recovery period for structures. Our oppositions is based on the pressing need for more, not less, investment in structures and on the many adverse effects of discouraging such investment for all structures, for used structures, or for non-owner occupied structures.

C. Proposals to change partnership, corporate and accounting rules

Several of the proposals characterized as dealing with partnership, corporate, and accounting rules would affect real estate investments. The most important of these are as follows:

(1) premature accrual of expenses;
(2) prepayments of expenses;
(3) deferred payments of indebtedness;
(4) like-kind exchanges of partnership interests;
(5) partnership allocations and distributions;
(6) treatment of property contributed to a partnership;
(7) retroactive allocations of partnership taxable income and loss;
(8) related party transactions;
(9) distributions in liquidation of a corporation;
(10) earnings and profits of a corporation; and
(11) dividend distributions of appreciated property.

D. Proposals to change the ACRS recovery period for structure

The staff of the Joint Committee on Taxation (JCT), the Congressional Budget Office (CBO), and the Democratic Study Group (DSG) have listed as a revenue raising option the extension of the cost recovery period for all structures from 15 to 20 years.[1]

Senator Dole last week included in the deficit reduction package presented to the Senate Finance Committee a proposal to extend the cost recovery period for used structures from 15 to 20 years.[2]

According to press reports, the OMB presented a "Menu" of revenue increases in the deficit reduction talks that included a proposal to extend the cost recovery period for non-owner occupied structures from 15 to 20 years.

III. Comments on the proposed changes in the tax law regarding partnerships, corporations, and accounting rules

A. Introduction

These comments are addressed to the proposals changing certain partnership and accounting rules contained in the Fiscal Year 1985 Budget submitted by the Administration to Congress on February 1, 1984 (the "Administration proposals") and similar proposals circulated by Senator Dole on November 16, 1983 (the "1983 Dole proposals"). The comments also address two other proposals dealing with changes in the taxation of corporations that would have adverse effects on the formation of capital for many types of business and industrial ventures.

While no legislative language is available for any of the proposals at this time, these comments reflect the best understanding of the proposals that can be obtained from the available documents and discussions with those who prepared them.

B. Effective dates and grandfather clauses

The comments that follow discuss in detail the substantive impact of certain proposals. However, the date on which the proposals become effective also is of great importance. BOMA strongly urges that effective dates be selected that are prospective. They certainly should be no earlier than the date of enactment in order to be fair to all taxpayers and to give taxpayers time to modify pending business transactions. We believe that retroactive changes in the tax law are unconscionable and violate the standards of fairness and decency that should characterize the relationship between the government and its citizens.

The proposals also should contain "grandfather" clauses to protect transactions entered into pursuant to contracts which are binding on the taxpayer on the effective date and transactions pursuant to which properties have been acquired or construction, reconstruction or rehabilitation begun. A small number of transactions will inevitably be entered into shortly before the effective date, but the problems of curtailing existing legitimate business activity by imposing retroactive effective dates are far greater.

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[1] *Reducing the Deficit: Spending and Revenue Options*, Congressional Budget Office, February 1984, Part III, at 223.

[2] *Summary of Possible Revenue Items in Proposed Deficit Reduction Package to be Considered by the Senate Finance Committee*, February 23, 1984.

The recent practice of making tax law changes effective on the date they are proposed is particularly inappropriate for these provisions. Such action would either freeze the market, preventing what the Administration agrees are legitimate and productive transactions, or require people to guess as to what will be enacted and with what modifications and amendments. We submit that making the tax law a game of chance is not good policy.

C. Premature accrual

1. Present law.—Under the accrual method, deductions are allowed (1) when all events have occurred which establish the fact of the liability giving rise to the deduction, and (2) the amount can be determined with reasonable accuracy.

2. Proposal.—The "all events" test would be clarified to provide that no deduction would be allowed until economic performance occurs. For example, a deduction would be permitted when services are performed, when use of property occurs and, in the case of workmen's compensation or similar liability, when the liability is satisfied. An exception to this rule would be provided for cases in which economic performance will occur within one year after the end of the taxpayer's taxable year. Exceptions to this rule would made for transactions to which other sections apply, for example, for the deduction allowable under section 166 (relating to bad debts). Also, the net operating loss carryback rules would be amended to allow losses to be carried back to the year in which the obligation generating the loss arose.

3. Comments.—The Administration proposal would only restrict deductions where "economic performance" has not occurred. In this context, the performance of services and the forebearance of money owed should be considered "economic performance." Thus, payment may be accrued so long as the goods or services for which the payment was owed have been received or performed. If or understanding of economic performance is correct, we believe this is a reasonable approach.

D. Prepayments of expenses

1. Present law.—Under the cash method of accounting, deductions are allowed for expenditures in the year paid. Prepaid interest is treated as paid in the period to which it is allocable (*i.e.*, cash basis taxpayers report interest as if they were on the accural methods).

2. Proposal.—The deduction of prepaid expenses prior to the period to which the expenses are allowable would be prohibited to "syndicates" other than farming. The prohibition would apply to both cash and accrual taxpayers.

3. Comments.—The prepayment of expenses has the potential for abuse. We point out, however, that there are many instances of legitimate and customary business practices that provide for the prepayment of expenses for non-tax related reasons. For example, most forms of insurance and many real estate taxes are paid once a year and in advance. Similarly, taxpayers may prepay expenses to simplify or minimize billing, bookkeeping, and other associated administrative costs for the payee as well as the taxpayer. Under current case law, as set forth in *Zaninovich* v. *Commissioner*, 16 F.2d 429 (9th Cir. 1950), prepayments of expenses for up to one year after the date of payment are currently deductible. We believe this is a reasonable and appropriate standard which eliminates the potential abuse of prepaying expenses many years in advance, but which does not impose costly and burdensome requirements on legitimate business transactions.

E. Deferred payments

1. Present law.—Unstated interest on deferred payments on the sale or exchange of property is allocated proportionally to payments (Section 483). The safe-harbor interest calculations are made on a simple rather than compound basis. The original issue discount rules generally do not apply to bonds or other indebtedness issued for property, or to obligations issued by an individual.

2. Proposal.—Section 483 would be revised so that interest rates would differ depending on the maturity of the obligations and be adjusted every six months. Further, the safe-harbor interest computations would be made on a compound interest basis. The proposal also provides that imputed interest would be taken into account under the periodic inclusion rules of section 1232A (and the corresponding rule for deductions in sec. 163(e)). The maximum test rate for real estate transactions between related parties under present law would be retained. The exception to section 483 for sales of ordinary income property would be repealed. The capital asset limitations and the natural person exceptions to section 1232A would be repealed.

The scope of the original issue discount (OID) rules would be expanded to include the purchase or use of property or services for discount obligations where neither the property or services nor the obligations are publicly traded. This means that the seller of property on the installment basis would have to report as taxable income all interest accrued on the installment obligation (whether or not received), even if he is a cash basis taxpayer. In these cases, the amount of the interest which is deemed to accrue would be determined by reference to the interest rates under section 483. Exceptions to the expanded OID rules would be provided for transaction such as sales of farms by indivduals or closely held businesses, sales of principal residences, and sales involving payments of $250,000 or less. For these excepted transactions, deductions for discount interest would not be allowed and discount incomes would not be recognized prior to the time of payment.

3. Comments.—This proposal would have an adverse effect on the sale and preservation of real property generally. First, the proposal would require a cash basis seller to be taxed on "phantom" or imputed income which the seller would not actually receive until years in the future. Thus, sellers would be penalized for financing a sale of their property. This would have a serious negative impact on the transfer of property, especially during periods of high inflation and economic difficulty. In effect, this rule would arbitrarily force the cash basis taxpayer to be taxed on an accrual basis. As a result, economically troubled businesses might be prohibited under these provisions from negotiating the deferral of payments to creditors and suppliers who would be willing to assist such businesses in surviving periods of financial difficulty.

The second problem under the rule is the requirement that the imputed interest be calculated on a compound basis rather than as simple interest. This proposal runs contrary to historic and customary practices in the U.S. real estate industry, as well as many state laws which required real estate interest calculations to be made on a basis of simple interest.

The rationale for this proposal is a highly theoretical economic analysis of deferral payment transactions. It ignores the enormous variety of transactions that occur in the real world, and forces everyone to conform to an economic model which may be at variance with legitimate business concerns.

It is appropriate for the Congress and the Administration to be concerned about abuses transactions in which interest is accrued that will never be paid and values are inflated artificially. However, abuses of this nature can and have been dealt with under the recently enhanced IRS enforcement and penalty procedures. If further action is necessary, the proposed rules should only be enacted if they include (1) a safe harbor which would apply if the purchaser of an obligation on an installment basis paid at least 50% of a market rate of interest on an annual basis and accrued the balance and (2) low-income housing transfers are exempted. This exemption is necessary because the cash flow with which to pay any portion of additional interest resulting from a second mortgage is not available.

F. Like-kind exchanges of partnership interests

1. Present law.—Case law permits an exchange of a partnership interest in one partnership for a partnership interest in another partnership to be made tax-free under certain circumstances. (*Gulfstream Land and Development Co.,* 71 T.C. 587 (1979)).

Also, case law permits tax-free deferred like-kind exchanges if completed within five years. Thus, for example, an owner of property can transfer it in exchange for the right to designate a piece of like-kind property to be given for his property. If the property is received within five years, the like-kind rules apply. (*Starker* v. *United States,* 602 F.2d 1341 (9th Cir. 1979)).

2. Proposal.—Tax-free, like-kind exchange treatment would be unavailable for exchanges of partnership interests in different partnerships. Also, gain would be recognized generally on like-kind exchanges that were not completed within 90 days after the property transferred is relinquished.

3. Comments.—We understand that the question of the transferability of limited partnership interests has been treated differently by different courts and that there is uncertainty in the law regarding this question. While we understand the arguments on both sides, and might prefer a different answer, we believe that the basic thrust of this proposal is—or should be—to deal with the tax-free exchange of limited partnership interests.

However, the proposal goes well beyond this objective to preclude the exchange of general partnership interests on a tax-free basis. Recent court decisions such as *Gulfstream Land and Development Corporation,* 71 T.C. 580 (1979), have held that general partnership interests are sufficiently distinguishable from stocks, choses in action, etc., to be excluded from the parenthetical language under Section 1031 and therefore, should, be entitled to non-recognition treatment under certain circumstances. These holdings stand for the proposition that non-recognition treatment should be available for general partnerships, at least where the holder of the partnership interest is actively engaged in the partnership business as a general partner and the underlying assets of the partnership would qualify for Section 1031 treatment.

There are legitimate non-tax motivated reasons for such transfers that are currently allowed. For example, it may be necessary for business reasons for partners to rearrange their holdings of partnership interests and/or diversify their partnership interests due to circumstances that are clearly recognized in the non-taxable corporate reorganization provisions. In these circumstances, it is understood and agreed that partnership liabilities should be considered and boot computed as if the assets and liabilities were exchanged directly. Thus, partners would be able to qualify for Section 1031 treatment (*see Magneson,* 81 T.C. 47) after liquidating their partnerhship interests. To exclude these interests from qualifying under Section 1031 would be inequitable and inconsistent with the overall thrust of the current statutes.

In addition, the requirement for specific and immediate identification of the qualifying property contained in the 1983 Dole proposal will cause serious problems in many real estate transactions. In many transactions, the taxpayer may have every intention to use the designated property in an exchange, but is unable to do so for some reason. If these proposals are adopted, what happens if the negotiations for an identified property fall through? Also, how are substitutions of property treated if the requirement for a substitution is beyond the taxpayer's control? To avoid these problems, the proposal should be modified to provide that the property for which the exchange is to be made must be specifically designated within one year after the close of the taxable year.

With respect to deferred, non-simultaneous exchanges, we agree that the five years allowed under *Starker* v. *U.S.,* 602 F.2d 1341 (9th Cir. 1979), may be too long, but the three month period contained in the Administration proposal generally will not be long enough to negotiate and close a real estate transaction.

G. Partnership allocations and distributions

1. Present law.—Subject to certain limitations, partnerships may make separate and independent special allocations of various items of partnership income, gain, loss, deduction and credit.

2. Proposal.—If a direct payment by the partnership for property or services would be chargeable to capital, distributions to a partner for such property or services would be treated the same as those made in a transaction between the partnership and one who is not a partner. Thus, those amounts would have to be capitalized. In addition, certain arrangements whereby a partner contributes property to a partnership and receives a contemporaneous distribution will be treated as a sale among partners or as a part sale/part contribution to the partnership.

3. Comments.—We agree that abuses may occur when partnerships are structured so that payments which should be capitalized are disguised in order to be deducted as an allocation of income. So long as the definition of items which must be capitalized follows current law regarding guaranteed payment, we believe the Administration proposal is a reasonable solution to this potential abuse. We oppose, however, the 1983 Dole proposal prohibiting all item allocations because it is overly broad and places unnecessary and unreasonable burdens on legitimate business arrangements.

H. Property contributed to a partnership

1. Present law.—Property can be contributed to a partnership and the gain or loss from its sale, or the depreciation or depletion generated by it, shifted between the partners without regard to the standards that govern allocations of partnership operating income or loss generally (such as substantial economic effect). Thus, the built-in loss on contributed property can be shifted from the contributing partner to the other partners. In addition, any depreciation or depletion from the property can be allocated to the partners regardless of their real economic interest in the partnership.

The character of property contributed to a partnership generally depends on the relationship of the property to the partnership business. Thus, assets that were ordinary income assets (inventory and unrealized receivables) in the hands of a partner can become capital assets in the hands of a partnership.

2. Proposal.—The rules relating to the allocation of depreciation, depletion, gains and losses on contributed property would be changed. Under these rules, any built-in gain or loss from a sale of the property would have to be allocated to the contributing partner. Depreciation and depletion would be allocated to the contributing partner and the other partners in proportion to their interests in the partnership.

Thus, the elective rule in present law to allocate gain or loss and depreciation and depletion so as to take account of pre-contribution appreciation or depreciation in the property would be made mandatory, with certain minor modifications.

Built-in losses on contributed capital assets would retain their character as capital losses for five years. Property that was inventory in the hands of a contributing taxpayer would retain its character as ordinary income property for five years in the hands of the partnership. Gain from unrealized receivables contributed by a partner would constitute ordinary income to the partnership.

3. Comments.—Use of the partnership structure should not permit taxpayers to escape "dealer" status or change the tax treatment of a particular piece of property, and the gain or loss attributable thereto, simply by making a contribution of the property to a partnership. However, the prevention of such practices can be accomplished in a more equitable manner than that of the Administration or 1983 Dole proposals.

In accordance with the Administration proposal, "built-in" gains or losses on contributed capital assets should be allocated to the contributing partner and should retain their character in that partner's hands for five years. Further, gains or losses attributable to that property in the five years subsequent to contribution should be treated for tax purposes—with respect to the contributing partner—as if the contribution had not taken place. For the remaining partners, however, the tax treatment of the property should be the same as any other property of the partnership. Under this structure, the contributing partner cannot reap any tax benefit by virtue of having contributed the property to the partnership, but the partnership is not unfairly penalized simply because of the pre-partnership tax status of a particular piece of property contributed to it.

I. Retroactive allocations

1. Present law.—Items of partnership taxable income attributable to that portion of the partnership's taxable year preceding a partner's entry into the partnership generally may not be retroactively allocated to him. However, deductible expenses incurred prior to a new partner's entry into a partnership can be assigned to a new partner by the partnership's use of the cash method of accounting and the deferral of the payment of the expenses until after the new partner's entry.

2. Proposal.—Retroactive allocations of partnership taxable income and loss would be prevented in the case of a cash basis partnership and a tired partnership arrangement.

3. Comments.—This proposal attacks a customary business practice by denying to partners deductions for expenses which may have been paid with funds they contributed to a partnership, if the obligation to pay those expenses was incurred prior to the partners' date of entry. Investor limited partners are normally brought into a partnership for the development of real estate over a period of time within which the partnership is moving forward on various elements of its business. Obligations are undertaken during this period in the expectation that investor limited partners will provide the funds with which to meet those obligations. It is inconsistent with normal business practice to deny cash basis taxpayers the right to deduct expenses paid prior to their entry to the partnership, particularly when the economic structure of the partnership anticipated paying those expenses out of funds provided by the new investor. In addition, the 1983 Dole proposal for computing allocations on a daily basis or on a strict prospective basis from the day a partner enters a partnership would place an unjustifiable administrative burden on the partnership. Many items, such as rental receipts, interest charges, ACRS depreciation under Code § 168 and the amortization of certain expenses relating to the beginning of a partnership's or corporation's business or acquisition of assets, use monthly accounting periods. Thus, partnership accounting and management information systems could accommodate a change in the law which permitted the partnerships to allocate to partners admitted to the partnership in a particular month only those expenses and other items attributable to the month. Although such a change in the law would be unjustified and inappropriate, it at least would be technically workable.

J. Related party transactions

1. Present law.—An accrural-basis taxpayer is denied a deduction for certain accrued expenses owed to a related cash-basis taxpayer unless expense is paid within 2½ months after the close of the taxable year in which expense is accrued. Partners and partnerships, and controlled corporations, are generally not treated as related for this purpose.

2. Proposal.—Taxpayers subject to this provision would be required to defer deductions for accrued interest and expenses owed to a "related" taxpayer until actually paid. The definition of "related" parties would be expanded to include partners, partnerships and controlled corporations regardless of the amount of common ownership interest.

3. Comments.—It is essential that some form of a *de minimis* exception be provided for common partnership interests. We believe that a minimum ten percent ownership in capital or profits would be appropriate *de minimis* rule. This minimum amount tracks the percentage used in the "anti-churning" provisions of section 168(e)(4) of the Internal Revenue Code for related parties.

There often are non-tax reasons, such as preserving the continuity of management, for allowing a minimum percentage of common ownership. Also, the ten percent minimum reduces the possibility that parties will become "related" inadvertent. For example, this would occur when one person purchased investment units in a new partnership which is the owner of property in which the person has, or even formerly had, an interest.

K. Distribution in liquidation

1. Present law.—Under section 337, except for recapture income, life inventory reserves and certain installment obligations, no gain is recognized to a corporation on a distribution of assets in complete liquidation of the corporation.

2. Proposal.—Distributions to shareholders of all items constituting ordinary income assets to a liquidating corporation would result in the recognition of gain to the corporation.

3. Comments.—This proposal would impose a double tax on the appreciation in value of corporate assets sold or distributed in a complete liquidation. This would effectively raise the capital gain tax on this element of gain from investment in corporate business from 20% to 42.4%.

This impact will be almost entirely on closely-held small and family businesses, because large, publicly-held companies seldom undergo complete liquidation. This is neither an efficient nor a fair tax increase, and BOMA recommends strongly against it.

Small and family businesses typically hold a wide range of business assets, including real estate from which their manufacturing, wholesale, or retail business may be operated. Small and family companies also hold real estate which has been collected and developed over a long period of years and is leased to third parties. These small and family corporations have paid full corporate income tax on their earnings, often over several family generations. The assets likely have appreciated substantially in value over a long period of years, in large part as a result of inflationary gains.

These corporations have operated their business based on certain fundamental assumptions as to our taxing system as it has operated for the last fifty years. As previously stated, they have paid a full corporate income tax on their regular taxable earnings, and a second shareholder level tax on any such earnings distributed as dividends. However, our system has not required them to pay a double tax on retained earnings reinvested in the business. Also, our tax system has provided that they would pay only a single capital gains tax on the appreciation in value of the underlying assets in their business upon selling or otherwise completely liquidating such business.

This proposal would impose a double tax on the appreciation in value of the underlying assets of a corporation, a gain which usually is largely an inflationary gain, and the effective tax rate would be increased from 20% to 42.4%.

In the short run, the result will be to encourage small and family corporations to merge their companies into large publicly-held companies in a tax-free exchange for the stock of the public company. Public companies with tax losses or with unused investment tax credits will seek to acquire such privately-held companies.

These substantial adverse effects far outweigh any possible benefits of the proposal.

L. Earnings and profits

1. Present law.—Distributions by a corporation to its shareholders constitute dividends only to the extent of the corporation's earnings and profits. Distributions of corporate assets to shareholders in excess of current and accumulated earnings and profits reduce the shareholders' bases for their stock, and any excess over stock basis generally is treated as capital gain.

2. Proposal.—All distributions by domestic corporations to their shareholders would receive ordinary income treatment.

3. Comments.—We strongly urge the retention of the present earnings and profits concept under which the characterization of distributions as ordinary income is determined.

The earnings profits limitation on the characterization of distributions as ordinary income should not be repealed.

The limitation of ordinary income treatment of corporate distributions to situations where a corporation has earnings and profits has been a fundamental concept in the taxation of corporate distributions for 70 years. It implements the principle of taxing a corporate shareholder only on distributions out of corporate income, not on the return of his invested capital. This basic principle of taxation is valid and should continue to be observed.

The taxation of capital that would result from the adoption of the proposal would adversely affect capital formation and competition through the new entry of businesses. Often the creators of a small business such as a strip office buildings must put a substantial amount of equity into new business because they cannot readily obtain financing. When the business has been established (often 5-10 years later), and financing is obtained, the original equity can be withdrawn tax free, as a dividend, for other uses. This proposal would tax at ordinary income tax rates this return of capital and would have a negative effect on the willingness of people to undertake business activity in the corporate form and on the free transfer of capital.

Many small businesses could be expected to respond to the enactment of this proposal by foregoing the protections of the corporate form and adopting the partnership form. This encouragement of the formation of partnerships rather than corporations is contrary to current IRS policy.

The repeal of the earnings and profits limitation was one of the proposals made by the Senate Finance Committee staff in its September 22, 1983, report on the reform and simplification of corporate taxation. The apparent abuses described in the staff report are specific deficiencies which can be corrected without eliminating the earnings and profits concept. None of those problems justifies such a fundamental change in tax policy. For example, one of the staff's examples is the corporation that borrows against the unrealized appreciation in its assets in order to distribute the proceeds when it has little or no earnings and profits. If this is a frequent problem, a simple amendment to section 312 can correct it. Another example—the distribution of debt obligations—is currently addressed by the income tax regulations. It would seem that any problems under the existing rules could be cured by revising the regulations.

Repeal of the earnings and profits limitation rules cannot simplify the tax laws. The earnings and profits concept is used throughout the Internal Revenue Code, and the staff's preliminary report states that the concept will be retained for other purposes. Most, if not all, corporations will have to continue to compute earnings and profits. For example, domestic corporations will use the concept for affiliated corporations rules, accumulated earnings tax, and section 306 "bailout" purposes, etc. Corporations with foreign subsidiaries will be required to continue to compute earnings and profits for foreign tax credit, controlled foreign corporations, and section 1248 recapture purposes. Under the proposal, the earnings and profits concept is not being eliminated except for dividend determination purposes.

While the simplification of the earnings and profits calculations is a desirable objective, and there is much to be said for developing a better definition of the concept, there is no necessity for the elimination of the earnings and profits limitation on the characterization of distribution as ordinary income.

M. Dividend distributions of appreciated property

1. Present law.—Generally, a distribution of appreciated property by a corporation with respect to its stock is not a taxable event to the distributing corporation, except in certain redemptions (the *General Utilities* doctrine).

2. Proposal.—Any ordinary, non-liquidating distribution of appreciated property would be taxable to the distributing corporation. Certain exceptions of present law (relating to partial liquidations, carryover basis situations and qualifying stock distributions) would remain.

3. Comments.—Requiring recognition of gain (or loss) at the corporate level whenever a corporation makes a distribution of appreciated property to its shareholders, even in liquidating distributions, would repeal the *General Utilities* decision in its entirety and constitute a fundamental change in the tax law. Such a change would upset many taxpayers' justifiable reliance on long-settled tax treatment and impose an economic hardship on many corporations and their shareholders. The Congress should not undertake such a significant reversal of longstanding tax policy without first identifying and evaluating all its potential effects.

Repeal of *General Utilities* and related statutory nonrecognition rules would extend the present burdens of the two-tier corporate-shareholder tax structure to all corporate liquidations and redemptions. The economic problems caused by the failure to integrate our individual and corporate income taxes are likely to be aggravated, unless a repeal of the *General Utilities* decision is accompanied by some form of relief provision to alleviate this double tax burden.

Furthermore, repeal of the nonrecognition rules of *General Utilities* and Code sections 311, 333, 336 and 337, without any accompanying measures to alleviate the impact of such a change, will discourage smaller taxpayers from adopting otherwise appropriate uses of the regular corporate form. Many small taxpayers will be induced to forego the nontax benefits and protections of incorporation in order to escape taxation of the same gain at two levels. As a result, any increased simplicity and certainty achieved by the Subchapter C revision will risk being effectively undone to the extent that taxpayers opt for a single level of partnership taxation despite Subchapter K's complexities and uncertainties.

If the Congress decides to repeal the nonrecognition rules of *General Utilities* and the corresponding statutory provisions, BOMA urges that the Congress simultaneously enact relief measures to prevent or reduce potential adverse effects of the change. A shareholder credit for taxes paid on appreciation by a distributing corporation would greatly reduce the immediate adverse impact of the proposed rules in many situations.

IV. Reasons for not changing ACRS for structures

A. Reasons for not extending the ACRS recovery period structures from 15 to 20 years

1. Needed stimulus to business investment.—During the two decades prior to the enactment of ERTA, there had been a substantial shift in investment away from real estate. A 1981 study of the Federal Reserve System determined that investments in structures, and especially in private non-residential buildings, had decreased substantially as a percent of Gross National Produce (GNP) and as a percent of total business fixed investment since the mid-1960s. This change was characterized as "an important shift in the composition of capital spending . . .[3] The Federal Reserve Board concluded that the shift in capital spending away from structures probably was related in part "to changes in the tax code which generally have favored equipment more than structures," and in part to the effects of inflation.[4]

In 1981, Congress enacted a program of significant multi-year tax reductions to ensure economic growth in the years ahead. ERTA was enacted because of concern that the performance of the economy had fallen far below its potential and that this condition would continue without a change in tax policy.[5] One element of ERTA's tax reduction program was a liberalized and simplified depreciation system, the Accelerated Cost Recovery System (ACRS). ACRS was designed to encourage new capital investment and to offset the effects of inflation on the real value of depreciation deductions.[6]

According to a Coopers & Lybrand analysis done for the National Realty Committee, compared to prior to law, ACRS has increased Gross Private Domestic Investment, increased the capital stock of commercial and rental residential structures, benefited equipment far more than structures, and increased federal tax revenues.

The analysis shows that, compared to present law, increasing the recovery period for structures to 20 years would decrease Gross Private Domestic Investment, decrease the capital stock of commercial and rental residential structures, increase the stock of equipment, and decrease federal tax revenues.

2. The 15-year cost recovery period is a needed protection against inflation.—The 15-year cost recovery period for structures serves as a protection against inflation by reducing to some degree the impact of inflation on cost recovery deductions, especially for long-lived assets such as structures.

Because capital income often is earned years after the associated costs of earning it are incurred, inflation tends to overstate capital income and reduce capital deductions such as depreciation. This results in capital income being overtaxed, and in some cases results in a tax on capital. This problem occurs whenever there is inflation, even if the rate of inflation is declining.[7]

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[3] Board of Governors of the Federal Reserve System, *Public Policy and Capital Formation,* 4-5, (Apr. 1981).

[4] *Id.* at 66.

[5] Staff of Joint Committee on Taxation, 97th Cong., 1st Sess., *General Explanation of the Ecomomic Recovery Act of 1981* 75 (Comm. Print 1981).

[6] Congressional Budget Office, *Revising the Individual Income Tax* 95 n.39 (July 1983).

[7] Congressional Budget Office, *Revising the Individual Income Tax* 68 (July 1983).

One of the reasons for enacting ACRS was to partially offset the effects of inflation on the real value of depreciation deductions.[8] Thus, the Treasury has described ACRS as providing an "approximate inflation adjustment." [9]

An extension of the 15-year recovery period for structures to 20 years would seriously diminish this protection against inflation.

3. A 20-year cost recovery period would not increase tax revenues.—The proposed lengthening of the cost recovery period for structures would not increase tax revenues to the extent suggested by the Congressional Budget Office (CBO). This is because the CBO estimates of the revenue impact of individual tax increases do not take into account the negative feedback effect, *i.e.*, reductions in tax revenues caused by reductions in economic activity.

In fact, the Coopers & Lybrand/NRC model indicates that such a proposal would *decrease*, rather than increase, the flow of revenue to the federal treasury.

4. A 20-year cost recovery period would increase the misallocation of capital away from structures.—The 15-year cost recovery period for structures does not equal the benefits given other assets. Under prior and current law, structures, as compared to other assets, suffer a disadvantage in the effective tax rates they pay and in their ability to attract investment capital. This bias has been identified by the Congressional Research Service, which has concluded that it produces a misallocation of investment and creates inefficiencies in the economy that cost billions of dollars annually. An extension of the current period would increase the bias against structures and the cost to the economy.

Jane G. Gravelle, a taxation specialist in the Congressional Research Service (CRS), has published a number of studies assessing the impact of tax law provision on effective tax rates and on the allocation of investment capital among assets and industries. According to Gravelle, the bias in favor of short-lived assets produces a disparity in effective tax rates by type of asset that results in a misallocation of capital. This misallocation of capital produces economic inefficiency, which she describes as "deadweight loss." [10]

Any reduction in the return on investments in structures will add to the bias of effective tax rates against structures and will increase the "deadweight loss" to the economy.

The conclusions of the CRS studies have been supported by "Citizens for Tax Justice." [11]

The substantial bias of the tax code against investments in structures and its distortionary effect also have been established by Harvard economics professor Alan J. Auerbach. Professor Auerbach concluded that the present value of depreciation allowances for structures under ERTA was roughly one-half that for equipment.[12]

Professor Auerbach has reaffirmed this conclusion in a recent Brookings Institution paper. In a study of effective corporate tax rates by industry and by asset type, he concluded that there are "massive distortions across industries, and within any given industry," because income from structures is subject to much higher effective tax rates than income from equipment. For example, in 1982, while the effective tax rate for general industrial equipment was 8.4 percent, it was 42.1 percent for industrial structures.[13]

The 1982 Economic Report of the President also concluded that ACRS under ERTA favored investments in machinery, equipment and vehicles over investments in industrial and commercial buildings [14] and that this would create economic inefficiency.

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[8] Staff of Joint Committee on Taxation, 97th Cong., 1st Sess., *General Explanation of the Economic Recovery Act of 1981* 75 (Comm. Print 1981).

[9] *Miscellaneous Tax Bills: Hearings Before the Subcommittee on Taxation and Debt Management of the Senate Finance Comm.*, 98th Cong., 1st Sess. (1983) (Statement of Ronald A. Pearlman, Deputy Assistant Secretary (Tax Policy), Dept. of the Treasury).

[10] *See, e.g.*, J. Gravelle, *Effects of the 1981 Depreciation Revenues on the Taxation of Income from Business Capital* 35 National Tax Journal 45; J. Gravelle, *Effective Corporate Tax Rates and Tax Changes in the 97th Congress* 3, 6 (1983) (Congressional Research Service).

[11] Citizens for Tax Justice. *Effective Corporate Tax Rates on the Income From New Investments Under the Reagan Accelerated Cost Recovery System* (Feb. 1982); R. McIntyre, *Inequity and Decline* 39–42, 103 (1983).

[12] Auerbach, *The New Economics of Accelerated Depreciation*, 23 Bost. Col. L.Rev., 1327, 1346, 1347, 1350 (1982).

[13] A. Auerbach, *Corporate Taxation in the United States*, 451, 467–9, Brookings Papers on Economic Activity 2, 1983.

[14] *Economic Report of the President*, 124 (Feb. 1982).

5. The 15-year cost recovery period is reasonable compared to pre-ACRS depreciation.—The 15-year cost recovery period for structures is reasonable when compared to the cost recovery periods for structures that were taken by taxpayers and approved by the courts under prior law.

However, there is a misperception that structures received greater benefits from ERTA and TEFRA than they actually received. One reason for this misperception was the unreasonably long depreciable lives advocated by Treasury under prior law.

The establishment of 15 years as the recovery period for all structures under ERTA resulted in a lesser reduction of the recovery period for structures than would appear from comparing the Treasury guideline lives of 40 to 50 years for structures under prior law with the 15-year recovery period for structures under ACRS.

Also, part of the misperception of the size of the tax benefits of ERTA and TEFRA for structures arises from the consideration of only the benefits of the 15-year ACRS recovery period for structures and from the failure to consider the impact of other tax law changes enacted in ERTA and TEFRA which reduced the tax benefits of investments in structures.

The benefits of the 15-year recovery period for structures were offset by such changes in the tax law affecting structures as the elimination of component depreciation, the imposition of more restrictive construction period interest and tax deduction provisions, the adoption of more restrictive recapture rules for those who elect accelerated cost recovery methods, and an alternate minimum tax assessment affecting capital gains.

In addition, under the uniform 15-year cost recovery period, some investors, particularly in used structures, sacrificed the right to establish shorter useful lives under a facts and circumstances test.

6. The amount of investment in real estate in 1983 is not excessive compared to prior levels.—Investment in structures enjoyed a resurgence in 1983. This increase was all in the residential sector, with nonresidential real estate showing a slight decline from 1982. However, neither the level nor the rate of residential investment in real estate was excessive compared to the pattern of such investment in prior years.

In 1983, after four years of decline, the constant dollar value of total new residential and nonresidential buildings (excluding farm and public utilities structures) put in place increased from $89 to $110 billion. Even after this increase, the level of investment in 1983 is less than the level recorded in previous years. The constant dollar value of new residential construction put in place increased from a 12 year low of $47.2 billion in 1982 to an estimated $70.9 billion in 1983. This amount is also below the levels reached in prior years.

For all these reasons, the 15-year cost recovery period for structures should not be extended to 20 years.

B. Reasons for not extending the ACRS recovery period for used structures

If all used structures must be depreciated over 20 years, the ACRS recovery period for such structures will be increased by one third. The 15-year recovery period was enacted to stimulate investment in structures and to offset the effects of inflation on depreciation deductions. This proposal would result in a heavier tax burden on many used structures than pre-ACRS law when many used structures could be depreciated in less than 20 years. This proposal would therefore provide a disincentive to investment in structures compared to pre-ACRS law.

By increasing the effective tax rate on income from used structures, this proposal also would increase the misallocation of capital away from structures. By discouraging sales of used property, it would further cause as misallocation of capital as the onwership of real property is not transferred in response to changing economic conditions. These misallocations would create economic inefficiency and retard economic growth.

By strongly discouraging the sale of used real property, this proposal also would greatly reduce the amount of rehabilitation of older buildings in central cities, a process generally occurring after sale to a new owner. The reduced sales also would reduce federal capital gains tax revenues.

C. Reasons for not extending the ACRS recovery period for nonowner occupied structures

Reduced cost recovery allowances for leased property would result in increased rental prices This would force some tenants to own structures when economic circumstances would otherwise favor leasing. For tenants unable to purchase real property, the proposal would add to their cost of shelter or their cost of doing business.

Forcing businesses to own structures would reduce economic efficiency by impairing the ability of such businesses, with their capital tied up in illiquid real property, to respond to changing economic conditions and by reducing specialization in real property operation.

Raising the rents of business tenants unable to own structures would distort investment among various sectors of the economy, distort investment by asset type within industries, unfairly discriminate against new and small businesses, and create a barrier to entry of new businesses, thus reducing competition.

For families unable to afford their own homes, this proposal would increase the cost of basic shelter.

V. Conclusion

BOMA urges the Committee to be cautious in attempting to deal with the perceived abuses of the partnership, corporate, and accounting rules. It is important that capital formation in the office building industry, and in other sectors of the real estate industry, not be impaired by remedies for these problems. Any proposals adopted by the Committee should be carefully drawn to affect only those problems that cannot be remedied with strict enforcement of existing law, and not to affect legitimate, non-tax motivated transactions. The ACRS recovery period for structures should not be extended.

STATEMENT OF DEBORAH J. CHOLLET, PH.D., SOPHIE KORCZYK, PH.D., AND EMILY S. ANDREWS, PH.D.[1]

EMPLOYEE BENEFITS—EQUITY, TRENDS AND FEDERAL REVENUE IMPLICATIONS

The growth of employee benefits as a tax-favored form of compensation has dominated the debate over federal tax policy for several years. Many who are concerned about the federal deficit, and many observers of Social Security's financial problems, see the growth of tax-favored employee benefits as an erosion of the tax base and a threat to the government's ability to maintain services and honor past commitments.

The emergence of new forms of tax-favored employee benefits—such as deferred compensation plans and cafeteria plans—alarms those who see the growth of employee benefits only as erosion of the tax base. This appraisal of employee benefits is naive. The growth and redefinition of tax-favored employee benefits must be evaluated in a broader, more sophisticated context to design efficient long-run public policy.

Tax expenditures for employee benefits must be considered in terms of the social benefits that result. The emergence of new forms of employee benefits represents employer efforts to reduce benefits costs and, subsequently, total compensation costs. The growth of some new types of benefits may represent a net addition to the payroll tax base, if they supplant the growth of more traditional benefits.

The growth of employee benefits

Employee benefits can be considered in three groups: Legally required benefits (including employer contributions to Social Security, unemployment insurance and workers compensation insurance); fully taxable benefits (primarily, payment for time not worked); and tax-favored benefits (including employer contributions to pension and health insurance plans).

In 1983, tax-favored employee benefits (excluding federal, state and local government contributions to public employee pensions) represented just under 30 percent of all employee benefits and 8 percent of total compensation. Since 1950, tax-favored employee benefits as a share of compensation have grown at an average annual rate of 4.5 percent, compared to somewhat slower growth in legally required benefits and taxable benefits (see table 1).

Employer contributions to group health insurance are the fastest-growing component of employee benefits. The expansion of worker and dependents coverage under employer group plans, the enhancement of benefits under these plans, and persistent high inflation in health care costs have all contributed to the growth of employer contributions to health insurance as a share of compensation. Since 1950, employer health insurance contributions as a percent of total compensation have risen at an average annual rate of 6.3 percent. Reflecting continued high inflation in health care costs since 1980, employer contributions to health insurance have continued to grow in excess of total compensation at an average annual rate of 7 percent.

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[1] The authors are research associates of the Employee Benefit Research Institute. The views expressed in this statement are those of the authors and do not necessarily reflect the views of the Employee Benefit Research Institute, its trustees, members or other staff.

TABLE 1.—AVERAGE ANNUAL GROWTH RATES OF MAJOR EMPLOYEE BENEFITS AS A SHARE OF TOTAL COMPENSATION, 1950–83 [1]

[In percent]

Employee benefit	Average annual rate of growth		
	1950–80	1970–80	1980–83
Total Benefits [2]	2.5	2.3	1.9
Legally Required Benefits	3.2	3.3	1.5
Fully Taxable Benefits	1.4	.8	.8
Tax-Favored Benefits, Total [2]	4.5	4.2	4.1
Private Pension and Profit-Sharing	3.7	4.5	5.7
Group Health	6.3	5.1	7.0
Group Life	2.1	−1.7	....
Other			

[1] Data Resources, Inc. projections for 1983 total compensation. Estimates for 1983 assume continuation of 1980–82 growth rate.

[2] Excludes the Federal civilian retirement system, railroad retirement system, State and local retirement systems and military pension. Since these systems are not governed by the same funding standards that determine private employer pension contributions, the growth rates of private and public employer contributions are incomparable.

Source: Calculations from Chamber of Commerce data for 1951–81, and the National Income and Product Accounts, U.S. Department of Commerce.

Tax preferences and federal revenue loss

Private retirement program tax expenditures from the single largest category of tax expenditures in the federal budget. They arise from the deferral of taxes paid on pensions and retirement saving contributions, and earnings on these contributions. The tax deferral of pension and retirement saving contributions represent current revenue deferral; taxes are paid on withdrawals from the funds after the worker retires. In a lifetime context, however, gross federal revenue loss (excluding public entitlement expenditures that would result from lower levels of private retirement income) are significantly lower than measures of current revenue deferral suggest. As much as 75 percent of the real value of taxes deferred during pension participants' working careers is ultimately paid in retirement.[1]

Employer contributions to group health insurance are also a large source of current federal tax expenditures, fourth in the list of all tax expenditures by size. The exemption of employer health insurance contributions from Social Security, corporation income and individual income taxation is an important source of federal revenue loss.

Tax expenditure estimates are a poor guide for setting either federal tax policy or federal retirement or health policy.[2] Nevertheless, the high tax expenditure estimates for pension and group health insurance plans continue to draw the public's attention and appraisal of these plans' tax-favored status. Measurement of current or lifetime tax loss, however, is only part of the task of evaluating tax preference for employer pension contributions, retirement saving, and employer-sponored health insurance. The *benefits* that derive from tax preferences for these plans must also be appraised.

Federal tax preferences for pensions, retirement saving, and health insurance have encouraged high rates of participation in these plans among workers and their families at all income levels. Widespread coverage under these plans promises to enhance federal tax revenues in future years, and minimize current and future reliance on public entitlement programs.

Coverage growth in tax-favored employee benefits

Tax laws favoring employer retirement and health insurance plans were enacted under the premise that wide coverage of workers and their dependents under these plans is desirable social policy. In fact, between 1950 and 1979, the rate of worker participation in employer pensions grew by 23 percent; in absolute numbers, employee pension participation rose by 263 percent.[3] Econometric estimates suggest that, since 1960, 20 to 30 percent of that increase in employer pension contributions as a share of compensation can be attributed to favorable tax incentives and the growth of real marginal tax rates.[4]

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[1] S. Korczyk, *The Tax Treatment of Pensions and Deferred Compensation Programs* (Washington, D.C.: Employee Benefit Research Institute, forthcoming). These simulation results are consistent with calculations reported by R. A. Ippolito, "Public Policy Towards Private Pensions" *Contemporary Policy Issues*, No. 3 (April 1983), pp. 53–76

[2] See: D. Chollet, "Background on the Tax Treatment of Employee Benefits: An overview of the Issues" in D. L. Salisbury, ed., *Why Tax Employee Benefits?* (Washington, D.C.: Employee Benefit Research Institute, 1984).

Data collected by household and insurer surveys indicate that insurance coverage for major health care expenses, and access to health care services, has risen steadily among the population since 1960. In 1979, nearly 61 percent of the U.S. population received health insurance coverage from an employer group health plan. Among all persons with private health insurance coverage in 1979, at least 82 percent were covered by an employer plan.[5] Recent Congressional concern over health insurance loss among unemployed workers and their families suggests that the Congress continues to perceive high rates of private health insurance coverage as a public policy goal.

Widespread health insurance and pension coverage contribute importantly to the income security of current workers and their families, and to the income security of future retirees. Tax preference for employer health insurance contributions, employer pension contributions and individual retirement saving are a critical factor in determining participation and coverage. Nondiscrimination provisions in the tax code make tax benefits contingent on the breadth of the plan's coverage, that is, both high- and low-income workers must be included in tax-qualified plans.

The removal of tax preference for employer health insurance contributions might dramatically reduce rates of coverage among low-income workers and their families, among workers and their dependents who experience unemployment during the year, and among persons who are eligible for Medicaid or Medicare coverage.[6] An EBRI simulation of the probable pattern of coverage loss suggests that tax preferences for employer health insurance contributions strongly benefit low-income workers and their dependents, provide important security for workers with fragmented employment histories, and reduce the public cost of health care entitlement programs.

The tax deferral of employer pension contributions and individual retirement saving provides important incentives for employers and workers to provide for retirement income. The increasing importance of pensions as a source of income projected among future retirees is the direct result of past growth in pension plan participation among workers. The projected rate of pension recipiency among today's young workers (ages 25–34) is nearly twice that of workers who are retiring today (see table 2).

TABLE 2.—ESTIMATED PERCENTAGES OF FAMILIES RECEIVING PENSION BENEFITS AT AGE 65, AND AVERAGE REAL BENEFITS, BY CURRENT AGE AND MARITAL STATUS

Cohort age in 1979	All families		Married couples		Single persons	
	Percentage to receive benefit	Average amount of benefit	Percentage to receive benefit	Average amount of benefit	Percentage to receive benefit	Average amount of benefit
25–34	71	$12,417	75	$14,541	65	$8,701
35–44	65	11,190	67	12,563	60	8,823
45–54	52	8,656	58	9,621	41	6,496
55–64	37	5,315	44	5,548	26	4,718

Note.—Real dollars are calculated using 1982 as the base year.

Source: "Social Security: Perspectives on preserving the system" (Washington, D.C.: EBRI, 1982), p. 90.

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[3] S. J. Schieber and P. M. George, *Retirement Income Opportunities in an Aging America: Coverage and Benefit Entitlement* (Washington, D.C.: Employee Benefit Research Institute, 1981), pp. 54–55.

[4] S. Korczyk, *Ibid.*

[5] EBRI tabulations of the March 1980 Current Population Survey (U.S. Department of Commerce, the Bureau of the Census).

[6] D. Chollet, *Employer-Provided Health Benefits: Coverage and Policy Issues.* (Washington, D.C.: Employee Benefit Research Institute, 1984).

Equity—The income distribution of major benefits

In part as a result of tax incentives, participation in employer pension and health insurance plans is high. In 1979, 48 percent of total workforce participated in an employer pension plan; 74 percent were covered by an employer group health insurance plan. Among full-time full year workers, rates of coverage are very high. In 1979, more than 74 percent of full-time full-year workers participated in an employer pension plan, and 89 percent were covered by an employer health plan.[7] Participation in tax-favored individual retirement saving plans is more modest. In 1982, 13 percent of all households that filed a federal income tax return reported participation in an Individual Retirement Account (IRA).[8]

Employee benefits are widely distributed among workers and their families at all income levels. Reflecting the concentration of workers at low and middle incomes, most workers who participate in employer pension and health insurance plans are low or middle-income workers. In 1979, 75.3 percent of all workers who were covered by an employer pension plan under ERISA standards, and 80 percent of all workers covered by an employer group health plan, earned less than $20,000 (see table 3). The distribution of employer health coverage by family income (reflecting the prevalence of multi-earner households and dependents coverage) shows a similar distribution. In 1979, 71 percent of all nonelderly persons (workers and their dependents) covered by an employer group health plan reported adjusted gross family income less than $30,000. The median adjusted gross family income among persons covered by an employer group health plan in 1979 was less than $25,000 (see table 4).

TABLE 3.—DISTRIBUTION OF EMPLOYEES WITH PENSION AND HEALTH COVERAGE BY EARNINGS, 1979

[Amounts in millions]

Earnings	Employees with pension coverage		Employees with health coverage	
	Total	Percent	Total	Percent
Less than $20,000	27.8	75.3	58.3	79.8
$20,000 to $49,999	8.7	23.7	13.9	19.1
$50,000 and over	.3	.9	.8	1.1
Total [1]	36.9	100.0	73.0	100.0

[1] Detail may not add to totals because of rounding.

Sources: Pension distribution based on "Retirement Income Opportunities in an Aging America: Coverage and Benefit Entitlement" (Washington, D.C.: EBRI, 1981). Health distribution from EBRI tabulation the May 1980 current population survey (U.S. Department of Commerce, Bureau of the Census).

TABLE 4.—RATES OF EMPLOYER GROUP HEALTH INSURANCE COVERAGE AND EMPLOYER CONTRIBUTIONS TO COVERAGE AMONG NONELDERLY PERSONS BY FAMILY INCOME, 1979

[In percent]

Adjusted gross family income [1]	Persons with employer group coverage	Covered persons with employer contribution	Persons with employer contribution	Distribution of all persons with employer contribution
Loss [2]	3.1	80.0	2.5	0.3
$1 to $4,999	11.6	85.3	9.9	2.2
5,000 to 7,499	34.5	88.7	30.6	3.2
7,500 to 9,999	47.8	90.5	43.2	4.4
10,000 to 14,999	63.0	92.1	58.0	13.0
15,000 to 19,999	75.6	92.6	70.0	16.8
20,000 to 24,999	81.8	94.4	77.2	16.7

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[7] S. J. Shieber and P. M. George, *Ibid.*, pp 38 and 54; and D. Chollet, *Ibid.* Pension coverage rates for full-time full-year workers include only nonagricultural workers, age 25–64, with one year of service and working more than full-time. Health insurance coverage rates include all full-time nonagricultural workers who worked 50 weeks or more during 1979.

[8] U.S. Department of the Treasury, Internal Revenue Service, *Statistics of Income (SOI) Bulletin* (Winter 1983–84), p. 62.

TABLE 4.—RATES OF EMPLOYER GROUP HEALTH INSURANCE COVERAGE AND EMPLOYER CONTRIBUTIONS TO COVERAGE AMONG NONELDERLY PERSONS BY FAMILY INCOME, 1979—Continued

[In percent]

Adjusted gross family income [1]	Persons with employer group coverage	Covered persons with employer contribution	Persons with employer contribution	Distribution of all persons with employer contribution
25,000 to 29,999	83.2	94.8	78.9	14.2
30,000 to 34,999	84.8	94.8	80.4	9.8
35,000 to 39,999	84.4	94.9	80.1	6.1
40,000 to 49,000	83.1	94.5	78.5	6.8
50,000 to 59,999	82.8	92.8	76.8	4.0
60,000 to 74,999	76.0	91.3	69.4	1.7
75,000 or over	74.4	86.0	63.9	.6
Total, all persons	60.0	93.1	56.4	100.0

[1] Includes earnings, interest, dividends, other property income and pension income. Excludes income from public insurance and transfer programs.
[2] Includes some persons reporting no income in 1979.

Source: EBRI tabulations of the March 1980 current population survey (U.S. Department of Commerce, Bureau of the Census).

The distribution of IRA savings among income groups also suggests the effectiveness and wide distribution of IRA tax advantages at every income level. In 1982, 18 percent of all IRA accounts, and 14 percent of all IRA contributions, were made by households with adjusted gross income less than $20,000. More than a third of all IRA contributions—34 percent—were made by households with adjusted gross income less than $30,000.[9] In short, there is no evidence that tax preference for employee benetits or private retirement savings plans favor only highly paid workers.

Trends in employee benefits

The growth of new tax-favored employee beefits has alarmed those who see the emergence of these benefits simply as further erosion of the tax base. The growth of new benefits—in particular, Section 401(k) plans and cafeteria plans—however, generally represent an effort by employers to contain the cost of employee benefits.

The growth of employer pension costs has prompted several innovations in the design of retirement income plans. Section 401(k) plans, authorized by the Revenue Act of 1978, have become an increasingly popular tool for controlling employer pension costs. Employees are able to supplement employer contributions to a Section 401(k) plan with tax-deferred contributions of their own. A Section 401(k) plan allows employers to contain their retirement plan costs by encouraging employee retirement savings. In general, Section 401(k) plans probably represent a net reduction in employer pension contributions relative to the level that would be required to ensure adequate retirement income with lower employee retirement saving.

Section 401(k) plans also reduce the employer's projected cost of indexing retirement benefits. Although pension benefit increases are seldom automatic, most employers provide *ad hoc* cost-of-living adjustments for current retirees. Under current law, sponsors of defined-benefit pension plans cannot reserve against future *ad hoc* cost-of-living increases, even in cases where the plan has a clear history of providing those increases. *Ad hoc* increases, therefore, are funded from current contributions, offset against actuarial gains, or added to the plan's unfunded liability.

Section 401(k) plans—and other defined-contribution plans—represents a way to provide employees with some inflation protection in retirement, at substantially lower cost to employers. Defined contribution plans are automatically indexed, since the asset value of the plan generally rises with inflation. Inflation reserves, therefore, accumulate automatically.

Section 401(k) plans also meet the demand for retirement income security among mobile workers and workers with intermittent labor force participation. Employee contributions to Section 401(k) plans are, by law, fully and immediately vested. Short-tenure workers, therefore, are better served by 401(k) plans than by more traditionally plans. These workers, and workers with intermittent labor force participation, are protected because they can "roll over" the accumulated contributions and earnings of the plan into a tax-deferred individual retirement savings account.

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[9] EBRI tabulations of Internal Revenue Service data for tax year 1982.

As a result, Section 401(k) plans may particularly benefit young workers with high labor-force mobility and women who may leave the labor force for protracted periods.

The growth of cafeteria (or Section 125) plans also reflects employers' efforts to control the cost of employee benefits. (Cafeteria plans may include a reimbursement account or flexible spending account; they are not synonomous with, or dependent on, flexible spending accounts.)

Generally, the primary motive of employers in establishing a cafeteria plan is the containment of employer contributions to health insurance. In fact, "mature" cafeteria plans can be characterized as those which have broken the automatic link between inflating health care costs and employer support for health insurance coverage. Cafeteria plans encourage employees to elect less generous health insurance coverage, and substitute other benefits—both tax-favored and full taxable—for generous health insurance coverage. Like Section 401(k) plans, cafeteria plans enable employers to meet the benefits demands of an increasingly diverse workforce—including young workers and women—while controlling total benefits costs.

Cafeteria plans have emerged and matured despite the fact that regulations, or even detailed legislation, have not been provided. Alleged abuses in the design of some cafeteria plans, providing significant tax advantages to participants that are not available to workers without cafeteria plans, have recently come to the attention of this Committee. Where the Congress believes abuses exist, limits or guidelines for the use of benefits within cafeteria plans should be set. However, examples of possible abuses within cafeteria plans do not mitigate the overall efficiency of these plans and their cost advantages for both employers and employees.

Federal revenue implications

Many observers of the emerging changes in employee benefit plans have claimed that the development of new forms of employee benefits merely represents further tax base erosion. These claims, however, have been made lightly and with no supporting evidence. There are several reasons to believe that the growth of nontraditional benefits—in particular, Section 401(k) plans and cafeteria plans—may actually reduce further erosion of the payroll and individual income tax bases.

While employer contributions to traditional pension plans are entirely tax-deferred, employee contributions to Section 401(k) plans are taxable by Social Security. Employers have favored Section 401(k) plans as a means of reducing the level of contributions they might have to make if they offered only a traditional pension plan. If Section 401(k) plans do, in fact, substitute for the growth of more traditional pension benefits, they represent an addition to the current payroll tax base. This seems to be a favorable development for those concerned about near-term budget deficits.

The growth of cafeteria plans also implies potential growth of the payroll and income tax bases. Cafeteria plans typically include a menu of taxable and tax-favored benefits. Cafeteria plans encourage employees to elect less generous health insurance coverage, and substitute spending for other benefits—both taxable and tax-favored—for tax-exempt health insurance spending. As a result, these plans do not unambiguously represent erosion of the tax base.

Summary and concluding remarks

Tax laws favoring specific employer retirement and health insurance plans were enacted under the premise that wide coverage of workers and their dependents under these plans is desirable social policy. The growth of worker coverage by pension and health insurance since 1950 has been strongly encouraged by the tax advantages accorded these plans, and by the growth of real marginal tax rates.

Employee benefits are widely distributed among workers and their families at all income levels. Like all workers, most workers who participate in employer pension and health insurance plans are low- and middle-income workers. In 1979, more than 75 percent of all workers covered by an employer pension plan under ERISA standards, and 80 percent of all workers covered by an employer group health plan, earned less than $20,000. Contrary to the perceptions of many, there is no evidence that tax preferences for employee benefits favor only highly paid workers.

The past growth of private pension plan participation among workers, and the current growth of worker participation in Section 401(k) plans and IRAs represent private saving for retirement income. Considering the increasing cost of Social Security and the projected decline in the ratio of workers to retirees, private saving for adequate income replacement in retirement has emerged as a public goal. Private pensions, 401(k) plans and IRAs appear to serve that segment of the population who will be least adequately served by Social Security—middle-income workers and their families, as well as higher-income workers. Conversely, these persons continue to be the most important sourre of funding for the Social Security system and the public sector at large.

The emergence of nontraditional benefits warrants more careful scrutiny than it has been given. These benefits generally serve the interests of employers, who are seeking to contain benefits costs, and employees, who demand a more diversified package of benefits than ever before. Nontraditional benefits may serve best those workers whose needs are least adequately met by more traditional benefits—young workers and employed parents. Further, the growth of nontraditional benefits may actually contribute to the payroll and income tax bases, to the extent that they supplant traditional, tax-exempt or fully tax-deferred benefits. These implications of emerging nontraditional benefits merit further attention.

HOUSE OF REPRESENTATIVES,
GOVERNMENT ACTIVITIES AND TRANSPORTATION SUBCOMMITTEE,
COMMITTEE ON GOVERNMENT OPERATIONS,
Washington, D.C., February 24, 1984.

Congressman DAN ROSTENKOWSKI,
Chairman, House Ways and Means Committee,
Washington, D.C.

DEAR DAN: As part of our oversight function, the House Government Activities and Transportation Subcommittee held hearings on August 4, 1983, on "Revision of IRS Tax Deductions for the Arts." The hearings were prompted by a series in the Washington Post detailing overvaluation of non-cash donations to the Smithsonian Institution, which is also under our jurisdiction.

We understand that legislative discussions will begin shortly on how to rectify this problem of overvaluation at all levels: appraisers, accountants, lawyers, the IRS, the Treasury and the private sector recipients of the museums, colleges and universitites and other cultural institutions.

Of special interest to you may be some data we received today from the Internal Revenue Service as a follow-up to our investigation. Their detailed analysis of items reviewed by te IRS Arts Advisory Panel notes some *significant* areas of overvaluation abuse. They cite some shocking numbers that climb as high as an 8,889 percent overvaluation. Undervaluations for estate and gift taxes are equally alarming with one figure estimated at 1,100 percent.

Our final report is not yet available. However, we would like to share with you some of our draft recommendations, based on the hearing and the lengthy investigations conducted by the subcommittee.

(1) The President's Committee on the Arts and Humanities—Attorney Leonard Silverstein appeared before our subcommittee to air his three proposals.

(a) The Subcommittee supports a holding period raised from one year to two years to curb some of the schemes for quick turnover of donated property. We do not feel that a three-year holding period may provide greater benefits than a two-year period.

If a three-year period is the will of the majority, however, we feel there may be a need to exempt contemporary art work since their value may be affected by time constraints.

(b) We have no objection to raising the five-year carryover period to a 15-year carryover. However, the subcommittee would like an estimate on how many actual donors would be involved in this proposal. The revenue loss to the Treasury does not seem significant.

(c) Increasing the 50 percent adjusted gross income limit to 60 percent. We would have reservations on this step, based on a projected loss of revenues to the Treasury. However, Larry Lindsey of the Council of Economic Advisers, has questioned the accuracy of these figures. He noted that he provision was not to be retroactive but that some of the figures seemed to reflect this.

(2) Changes at the IRS Level:

(a) With donated art objects, the actual bill of sale from the donor's purchase should be submitted at the time the tax deduction papers are submitted to the IRS, not if and when an audit should occur. This statement should include the fee paid, the date of purchase, the method used to determine valuation, record of previous sales (if known) and detailed statements from an outside appraiser justifying the appraisal figure provided.

(b) There is no current requirement that donated property be appraised. The rationale for that needs to be reviewed and questioned, especially for donated art items above a certain base level, such as $10,000.

(c) On the IRS tax form 1099, when a work of art is purchased specifically for donation, both the seller and the buyer would report that cost on this form. This would insure the accuracy and provide a cross-checking of information. Both parties would be legally liable for the information.

(d) Museums should report the value of annual non-cash contributions on the 1099 form they file with IRS. (These forms apply to all tax-exempt institutions which may receive such donations.)

(e) IRS and the Treasury should be empowered to maintain a list of all tax shelter investors for a 7-year period, as requested by Assistant Secretary Chapoton. Thus, if the IRS discovers an improper tax shelter, such as many of these multiple art print scams, through an audit of one investor, the IRS can quickly locate others who may be involved. [Our hearing transcript notes that in 1981, the IRS Art Print panel recommended adjustments on 100 percent of the items totaling $71,431,000, that were submitted for deductions; in 1982, the same panel recommended similar reductions for 100 percent of items submitted again on a total $102.6 million in donations.]

(f) The IRS in-house art evaluation team is seriously understaffed and underfinanced in what is a major area for combating abusive tax shelters. To recruit highly trained and experienced personnel for the staff, not only should the IRS consider hiring those from academic and museum backgrounds but also those who have worked for major auction houses since they have first-hand knowledge of the actual art marketplace.

Likewise, there should be trained IRS staff on a regional basis to work with the Washington evaluation staff. In the field, a reliable review of the donation submission could be handled by those at GS-7 and GS-9 level as auditors if the necessary administrative information was submitted at the same time as the tax form. This does not require artistic expertise or assessment. At this level, the IRS/Treasury field workers would check that adequate and accurate information was provided.

Those with specific art expertise at either the regional or national levels (or both) could handle the next step of evaluation. At the field level, problem cases could be discussed with the donor. Since there is much controversy over the mediocre quality of Polaroid photos provided for the charitable contribution donation, the actual work could be viewed by an IRS/Treasury field worker either in the office or at the local site where it was being kept.

(g) Penalties:

Under the Economic Recovery Act and the Tax Equity and Fiscal Responsibility Act, the IRS was given major tools to combat serious overvaluation of donations by assessing major penalties—raning up to 30 percent of the overvaluation.

However, Commissioner Roscoe Egger notes in this statement to the House Government Activities and Transportation Subcommittee that "The Service did not receive additional resources to implement the provisions of the Economic Recovery Tax Act. We have requested additional resources to implement the provisions of the Tax Equity and Fiscal Responsibility Act." (p. 53 of August 4, 1983 hearing testimony.)

Without the necessary staff and support mechanisms, the penalty provisions will not be enforced and the problem of overvaluation will not only continue but will proliferate.

(3) The IRS Art Advisory Panel:

The IRS took a major step in January when it added a third panel of experts that will review works of Pre-Columbian, primitive, Far Eastern and Asian art. This should help to minimize fraud in this area.

The subcommittee also recommends that a similar panel be considered for evaluation of gems and minerals since the IRS spends from $2 million to $3 million annually on outside appraisals. A panel convened twice a year would be far less expensive than outside consultants and would offer a broad range of expertise.

(4) The Appraisers:

(a) At present, there is no uniform, national standard for licensing or certification among the various groups of appraisers who work in the art and artifacts field. Several professional appraisal associations already have (on paper) rigorous standards for membership and ethical practices. The composite could form the basis for a licensing or certification standard for national practice for those who wish to submit appraisals for tax purposes to the IRS.

This registry could also contain information on the individual's professional credentials (education, training, experience.)

The three major appraisal associations—American Society of Appraisers, Appraisers Association of America and the International Society of Appraisers—all favor expansion of professional standards because of the perception that appraisers are no longer credible because of various national and international scandals.

(b) Banning fraudulent practitioners:

Improper valuations result from a taxpayer's reliance on the integrity and standards of the appraiser. Federal legislation should ban any appraiser from submitting IRS appraisals for tax purposes (for a specified period of time, as determined by Les Shapiro, IRS Director of Practice) who has "engaged in disreputable conduct or is incompetent" as determined by professional peers and/or legal authorities within the Treasury and IRS Departments. [Similar bans apply to attorneys, accountants and auditors.]

(c) Appraisals are based on fair market value prices. It is easy for any appraiser to determine the value for items sold at public auctions, such as those sponsored by Sotheby's or Christie's. Information from these is readily attainable from either of these firms and is kept on up-to-date computer records. Items sold in the private market are more difficult to document since the sale price is not released.

For comparability purposes and to validate appraisals and their accuracy, the IRS should have computer equipment that will provide ready access to this information. It will also serve as a deterrent to fraudulent behavior by appraisers who know that these figures will closely be checked. This is only one of the factors in an appraisal, but it is a significant factor.

(5) The Museums and Universities:

(a) Museums, universities and other donee institutions share a legal responsibility for the works they accept from donors. Large museums possess trained curatorial staff who have full knowledge of the range of value of various works of art. (Small museums may not have these resources, so a minimum level annual budget may be a factor in this proposal.) If a museum accepts a donation at the face value stipulated by the donor, it should professionally feel that the appraisal is valid. There is room for disagreement among honest people, but the donor claims $100,000 and the museum staff claims the figure is closer to $10,000, this discrepancy must be resolved before the museum can accept the donation on the owner's terms. The donor, likewise, is free to shop around for another museum or university, but whatever institution accepts the gift must be prepared to justify the range of the appraisal.

(b) The American Association of Museums, in conjunction with the Institute for Museums Services, currently conducts a Museum Assessment Program (MAP). As part of this process, museums should be made aware of the need to have an acquisition policy to prevent the abuses of what is accepted, what is rejected or what is deaccessioned by the board and the staff of the institution.

For its own reporting and insurance purposes, all donee institutions should offer (require) to review an appraisal to confirm the procedural completeness of the document and to answer any questions that arise regarding range of figures.

(c) Museums should be required to report all non-cash contributions as part of their annual 1099 submission to the IRS. (See Section 2(d))

(6) The General Accounting Office:

The General Accounting Office has issued a report which specifically deals with ways to minimize abusive tax shelters ("With Better Management Information, IRS Could Further Improve Its Efforts Against Abusive Tax Shelters," August 25, 1983, Report GGD-83-63)

The Subcommittee strongly urges that Congress push for compliance with these recommendations by GAO:

(a) "At present, IRS does not have reliable information on the current size of the tax shelter abuse problem and thus does not have reliable information on the estimated revenue loss resulting from tax shelter abuse. Without such information, collected over time, IRS planners will be hampered in assessing current trends and predicting future ones. They will need such information in the future to make the best possible allocation of IRS resources and to target those resources wisely." (p. 15)

This would include a breakdown of the total case inventory in the Tax Shelter Program by tax year and shelter type and an inventory by number and characteristics of taxpayers (rather than by number of returns.)

(b) Resolution of tax shelter backlog problem:

"At its present pace of about 70,000 completed examinations annually, the March 31, 1983 Examination Division backlog of 314,516 tax shelter returns would take more than 4 years to process—even if no new cases were added to inventory." (p. ii)

Again, without the necessary provision of resources by the Treasury Department and the Office of Management and Budget, IRS cannot do this job.

(c) The "must work" approach is not working:

"Under the 'must work' approach IRS, in effect, has directed its examiners to examine every abusive tax shelter they identify, regardless of the extent or seriousness of the abuse; the time remaining before the statute of limitations expires; or the potential effect on the examination plan." (p. 20)

Noted the IRS Commissioner in October 1981:

"Obviously, taxpayers also know that we can't litigate every tax shelter case * * *. Many of those 8,500 cases [examined] were docketed as far back as 1975. They bear no relationship to tax shelters being marketed today. If and when they're closed, the case precedents may not have much impact on shelter sales that are going on now." (p. 21)

We hope these recommendations will be beneficial to you in your upcoming deliberations. Our oversight subcommittee stands ready to assist you in any way we can in the preparation of adequate legislative remedies to curb abuses in the appraisal and donation process.

Sincerely,

Cardiss Collins, *Chairwoman.*

Enclosure.

Addendum

(7) Other Tax Inequities Affecting Donors and Appraisals:

Since Congress is now turning it attention to tax inequities as part of the Budget process, it must also deal with the appraisal process that shortchanges the creators of works of art such as music, paintings, sculpture, manuscripts, etc. In 1969, all deductions were removed for such contributors except for the actual cost of materials. Yet if the individual died, the same work would immediately be assessed at full market value for IRS tax purposes.

The Subcommittee fully agrees with Daniel Boorstin, director of the Library of Congress, that it is unfair "to let dealers and others benefit from gifts, and not the creator." Today's tax laws encourage dispersion of a collection and make them into commodities rather than documents of the written and visual records of civilization and culture. "They [these collections] should be preserved and kept together so future students will be able to study them in one place," Boorstin said.

The inability to donate works in one's own name has led to various forms of subterfuge, according to our oversight investigation.

This could be corrected if the same guidelines that will apply to noncash charitable contributions of art works also applies to donors who happen to be creators. The subcommittee recommends that at least two independent appraisals be submitted with tax papers for each donated work and that these contributions be subject to the same scrutiny by the IRS Arts Advisory Panel as other donations. These would not be "unknown" artists, musicians and authors and thus their works would have a readily recognizable market value which would be relatively easy to assess and to document.

Because of profit margins, the donor's gift could be valued at wholesale rather than retail estimates. Or, the market value could be split between that portion that represents personal income and the portion that represents appreciation.

If the creator of a work sold the object and gave the money to a charitable institution, he or she would receive the full fair market value for the charitable deduction. But under the current 1969 guidelines, there is little incentive to donate a gift that offers no recognition of the artists' time and talents, but only the materials involved.

This inequity has existed for 15 years and demands prompt remedy by the Congress as it attempts to correct other tax abuses and to stem the erosion of gifts to the public and private institutions (see attachment.) We need to protect our National Heritage Resources through an amended form of H.R. 1285 which provides fairness to the donor as well as to the tax system.

Internal Revenue Service,
Department of the Treasury,
Washington, D.C., February 23, 1983.

Ms. **Kathy Burns,**
Subcommittee on Government Activities and Transportation, House Committee on Government Operations, Washington, D.C.

Dear Kathy: As requested in your January 20 letter to Karne Carolan, we have revised the display of the information on the activities of the IRS Arts Advisory Panel, and have enclosed the new information here.

Let me briefly review for you some details of this particular data display, which you agreed to on the phone in discussions with my staff.

(1) we have retained the same basic columnar format and income ranges

(2) we have restated the dollar figures from our January 9 reply to you as percentages

(a) for contributions, we have calculated percentages on overvaluations only, since there were almost no undervaluations in this area

(b) for estate and gift data, we have calculated percentages for all items which were increased or which were overvalued by the taxpayer

(3) in some cases, percentages have been adjusted slightly to meet the disclosure provisions of the Internal Revenue Code

(4) we have indicated Panel action on items involving an ADAA appraisal

(5) the last page of the enclosure contains notes on how the percentages were calculated, and on related matters

I trust this information is responsive to your needs.

With kind regards,

Sincerely,

DAMON O. HOLMES,
Director, Legislative Analysis Division.

Enclosure.

CONTRIBUTIONS: PANEL RECOMMENDATIONS (#30 THROUGH #35)

RANGE OF TAXPAYER VALUES	NUMBER OF ITEMS	NUMBER AGREED ITEMS (ADAA)	PERCENT OVERVALUED BY TAXPAYER LISTED BY ITEM (ADAA denoted by * preceding)			NUMBER UNDER STUDY (ADAA)	NUMBER OF ADAA
$0	18	5	225%	300%	40%	5	1
TO			306%	433%	306%		
$9,999		(1)	306%	350%		(0)	
$10,000	37	12	* 50%	300%	300%	6	8
TO			300%	433%	35%		
$14,999			140%	243%	30%		
			300%	130%	400%		
			* 33%	4900%	400%		
		(5)	150%	33%		(1)	
$15,000	51	16	* 100%	80%	100%	3	15
TO			650%	20%	260%		
$19,999			100%	20%	290%		
			50%	* 44%	73%		
			400%	* 47%	217%		
			100%	220%	204%		
			200%	100%	83%		
			* 130%	483%	106%		
			400%	75%	227%		
			25%	319%			
		(9)	100%	75%		(1)	
$20,000	41	23	60%	300%	48%	9	8
TO			360%	700%	208%		
$24,999		(6)	50%	633%	33%	(2)	
$25,000	63	30	5275%	233%	233%	8	13
TO			* 83%	100%	317%		
$29,999			83%	400%	257%		
			83%	733%	270%		
			40%	4867%	100%		
			180%	233%	100%		
			40%	495%	150%		
		(10)	2%	43%		(1)	

CONTRIBUTIONS: PANEL RECOMMENDATIONS (#30 THROUGH #35)

RANGE OF TAXPAYER VALUES	NUMBER OF ITEMS	NUMBER AGREED ITEMS (ADAA)	PERCENT OVERVALUED BY TAXPAYER LISTED BY ITEM (ADAA denoted by * preceding)			NUMBER UNDER STUDY (ADAA)	NUMBER OF ADAA
$30,000	37	19	136%	498%	71%	4	5
TO			102%	344%	2889%		
$34,999			50%	67%	5867%		
			71%	100%			
		(5)	760%	100%		(0)	
$35,000	39	23	180%	40%	1300%	3	13
TO			95%	* 40%	* 44%		
$39,999			200%	40%	11983%		
		(11)	2400%	143%	44%	(0)	
$40,000	22	13	78%	100%	735%	1	6
TO			33%	695%			
$44,999		(6)	220%	9850%		(0)	
$45,000	31	15	8889%	157%	80%	7	5
TO			13%	567%	1700%		
$49,999		(4)	260%	567%		(0)	
$50,000	31	16	900%	214%	* 67%	6	13
TO			* 67%	89%	67%		
$59,999		(11)	233%	57%	317%	(0)	
$60,000	19	9	118%	71%	33%	1	8
TO			500%	100%	68%		
$69,999		(7)	700%	300%		(0)	
$70,000	18	4	329%	50%	80%	2	2
TO			131%	900%	600%		
$79,999			88%	445%	133%		
		(1)	173%	1400%	17%	(1)	
$80,000	9	5	580%	467%		0	3
TO			415%				
$89,999		(3)	3700%			(0)	
$90,000	8	2	620%	650%		1	2
TO			443%	13%			
$99,999		(2)	58%			(0)	

CONTRIBUTIONS: PANEL RECOMMENDATIONS (#30 THROUGH #35)

RANGE OF TAXPAYER VALUES	NUMBER OF ITEMS	NUMBER AGREED ITEMS (ADAA)	PERCENT OVERVALUED BY TAXPAYER LISTED BY ITEM (ADAA denoted by * preceding)			NUMBER UNDER STUDY (ADAA)	NUMBER OF ADAA
$100,000	42	15	155%	300%	90%	5	15
TO			18%	186%	122%		
$149,999			1200%	67%	60%		
			400%	300%	78%		
			194%	733%	* 29%		
			233%	344%	92%		
		(11)	194%	567%		(1)	
$150,000	21	11	5900%	200%	* 19%	1	10
TO			500%	60%	20%		
$199,999		(7)	400%	30%	* 100%	(0)	
$200,000	16	14	43%			0	10
TO			2140%				
$249,999		(10)				(0)	
$250,000	25	15	2400%	60%		5	14
TO			* 54%	60%			
$499,999		(10)	36%	13%		(2)	
$500,000	7	4	* 30%			0	4
TO			* 26%				
$749,999		(2)	41%			(0)	
$750,000	12	5	* 50%	25%		1	2
AND			16%	60%			
OVER		(1)	1400%			(0)	

ESTATE & GIFT: PANEL RECOMMENDATIONS (#30 THROUGH #35)

RANGE OF TAXPAYER VALUES	NUMBER OF ITEMS	NUMBER AGREED ITEMS (ADAA)	PERCENT TAXPAYER VALUE WAS INCREASED LISTED BY ITEM (ADAA denoted by * preceding)			PERCENT OVERVALUED BY TAXPAYER LISTED BY ITEM (ADAA denoted by * preceding)	NUMBER UNDER STUDY	NUMBER OF ADAA
$0	38	16	567%	267%	592%	17%	7	0
TO			1100%	100%	60%	64%		
$9,999			19%	100%	550%	20%		
		(0)	757%	100%		100%	(0)	
$10,000	40	19	132%	50%	275%	233%	5	0
TO			96%	275%	582%	150%		
$14,999			213%	550%	275%			
			317%	175%	40%			
		(0)	108%	50%			(0)	
$15,000	72	35	50%	67%	133%	11%	9	0
TO			33%	53%	50%	260%		
$19,999			367%	67%	100%			
			167%	206%	67%			
			33%	39%	100%			
			33%	11%	740%			
			87%	194%	178%			
			200%	76%	18%			
		(0)	67%	47%			(0)	
$20,000	94	54	38%	200%	88%	300%	9	0
TO			75%	125%	125%	33%		
$24,999			127%	275%	150%			
			59%	50%	50%			
			82%	200%	25%			
			52%	50%	138%			
			63%	75%	50%			
			422%	50%	75%			
			88%	75%	75%			
		(0)	150%	200%			(0)	

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ESTATE & GIFT:  PANEL RECOMMENDATIONS (#30 THROUGH #35)

RANGE OF  |NUMBER|NUMBER|    PERCENT TAXPAYER VALUE     |      PERCENT OVERVALUED       |NUMBER|NUMBER|
TAXPAYER  |OF    |AGREED|         WAS INCREASED         |          BY TAXPAYER          |UNDER |OF    |
VALUES    |ITEMS |ITEMS |        LISTED BY ITEM         |        LISTED BY ITEM         |STUDY |ADAA  |
          |      |(ADAA)| (ADAA denoted by * preceding) | (ADAA denoted by * preceding) |      |      |
==========|======|======|===============================================================|======|======|
$25,000   |  123 |  63  |       50%        40%       60%|     67%                       |  16  |  2   |
TO        |      |      |      200%        60%       52%|     67%                       |      |      |
$29,999   |      |      |      180%        80%      140%|     67%                       |      |      |
          |      |      |       60%        60%       60%|     43%                       |      |      |
          |      |      |       80%        30%       20%|    100%                       |      |      |
          |      |      |       25%        80%       60%|     48%                       |      |      |
          |      |      |       43%        60%       80%|                               |      |      |
          |      |      |      132%        20%      200%|                               |      |      |
          |      |      |       25%       100%       28%|                               |      |      |
          |      |      |      186%       300%       10%|                               |      |      |
          |      |      |       79%       100%      100%|                               |      |      |
          |      |      |       61%       100%      140%|                               |      |      |
          |      |(0)   |      293%        40%          |                               |(0)   |      |
----------|------|------|-------------------------------|-------------------------------|------|------|
$30,000   |  64  |  29  |      100%       200%       72%|  59900%                       |  9   |  0   |
TO        |      |      |       33%       100%       41%|     58%                       |      |      |
$34,999   |      |      |       67%        67%       25%|                               |      |      |
          |      |      |      117%        58%       25%|                               |      |      |
          |      |      |       83%        25%       67%|                               |      |      |
          |      |      |      275%       100%      150%|                               |      |      |
          |      |      |       42%        42%      183%|                               |      |      |
          |      |(0)   |      233%       175%       50%|                               |(0)   |      |
----------|------|------|-------------------------------|-------------------------------|------|------|
$35,000   |  59  |  28  |       33%        14%       86%|    600%                       |  8   |  2   |
TO        |      |      |      122%        43%       50%|                               |      |      |
$39,999   |      |      |       71% *      21%      100%|                               |      |      |
          |      |      |      157%        86%       57%|                               |      |      |
          |      |      |       14%        71%       14%|                               |      |      |
          |      |      |       29%        79%       14%|                               |      |      |
          |      |      |      107%        50%          |                               |      |      |
          |      |(1)   |      329%        57%          |                               |(0)   |      |
----------|------|------|-------------------------------|-------------------------------|------|------|
$40,000   |  63  |  38  |      150% *      56%       73%|     14%                       |  6   |  2   |
TO        |      |      |      125%        31%       63%|     14%                       |      |      |
$44,999   |      |      |       88%       150%       44%|     33%                       |      |      |
          |      |      |      100%       100%       75%|                               |      |      |
          |      |      |      125%       100%          |                               |      |      |
          |      |(1)   |      100%        50%          |                               |(0)   |      |
----------|------|------|-------------------------------|-------------------------------|------|------|
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ESTATE & GIFT: PANEL RECOMMENDATIONS (#30 THROUGH #35)

RANGE OF TAXPAYER VALUES	NUMBER OF ITEMS	NUMBER AGREED ITEMS (ADAA)	PERCENT TAXPAYER VALUE WAS INCREASED LISTED BY ITEM (ADAA denoted by * preceding)			PERCENT OVERVALUED BY TAXPAYER LISTED BY ITEM (ADAA denoted by * preceding)		NUMBER UNDER STUDY	NUMBER OF ADAA
$45,000	37	13	56%	72%	100%	80%		7	1
TO			150%	178%	61%				
$49,999			150%	17%	150%				
			156%	78%	156%				
			61%	375%					
		(0)	33%	* 22%				(0)	
$50,000	61	35	50%	40%	18%	42%		5	2
TO			40%	60%	32%	235%			
$59,999			90%	20%	68%	66%			
			70%	995%	82%	101%			
			80%	50%	50%				
		(2)	20%	70%				(0)	
$60,000	33	13	54%	54%	17%	51%		5	1
TO			12%	12%	398%	154%			
$69,999			54%	92%	88%	99%			
		(1)	130%	58%	149%			(0)	
$70,000	29	11	61%	134%	83%	40%	17%	1	0
TO			115%	67%	67%	88%			
$79,999			71%	21%	60%	36%			
		(0)	61%	43%	27%	199%		(0)	
$80,000	28	14	88%	56%	44%	23%		3	0
TO			88%	112%	25%	183%			
$89,999		(0)	19%	56%	31%			(C)	
$90,000	12	6	94%	58%		125%		0	1
TO			89%			* 143%			
$99,999		(0)	67%					(0)	

ESTATE & GIFT: PANEL RECOMMENDATIONS (#30 THROUGH #35)

RANGE OF TAXPAYER VALUES	NUMBER OF ITEMS	NUMBER AGREED ITEMS (ADAA)	PERCENT TAXPAYER VALUE WAS INCREASED LISTED BY ITEM (ADAA denoted by * preceding)			PERCENT OVERVALUED BY TAXPAYER LISTED BY ITEM (ADAA denoted by * preceding)		NUMBER UNDER STUDY	NUMBER OF ADAA
$100,000	79	36	20%	20%	25%	67%		4	2
TO			44%	40%	77%	99%			
$149,999			20%	50%	13%	47%			
			60%	25%	127%	33%			
			100%	150%	59%	50%			
			44%	63%	43%				
			54%	40%	150%				
			73%	100%	100%				
			73%	63%	150%				
			61%	100%	50%				
			38%	300%					
		(2)	72%	50%				(0)	
$150,000	36	18	* 67%	32%	67%	148%		2	3
TO			33%	39%	41%	12%			
$199,999			67%	43%	25%	76%			
		(1)	67%	43%	25%	12%		(0)	
$200,000	22	13	11%	75%	11%	15%		0	0
TO			344%	25%	25%				
$249,999		(0)	30%	38%				(0)	
$250,000	36	21	75%	38%	33%	56%	20%	2	7
TO			15%	29%	67%	370%			
$499,999		(7)	9%	86%	200%	27%		(0)	
$500,000	7	4	50%			49%		0	2
TO			92%						
$749,999		(2)						(0)	
$750,000	6	5				187%		1	4
AND									
OVER		(4)						(0)	

NOTES:

1) Percent Overvalued by Taxpayer=

$$\frac{\text{Taxpayer Value - Panel Value}}{\text{Panel Value}} \times 100\%$$

2) Percent Taxpayer Value was Increased=

$$\frac{\text{Panel Value - Taxpayer Value}}{\text{Taxpayer Value}} \times 100\%$$

3) Under the NUMBER AGREED ITEMS and NUMBER UNDER STUDY, the number of ADA appraisals is in parentheses.

4) The column of undervalued items has been deleted on the Contributions listing because the actual taxpayer and panel values could be calculated by using this table and the previous table.

5) The column of overvalued items has been blanked for values under $50,000 on the Estate & Gift listing for the same reason as above.

6) Any ADA appraisals not accounted for with the existing entries would be found on the deleted or blanked entries.

7) In recalculating the Contributions listing, two errors were discovered. They were corrected in the $30,000 and the $35,000 ranges.

8) For disclosure reasons certain percents were changed from their calculated value. None of the percents that were changed differ from their original value by more than 1% of that original value.

CHARITABLE DEDUCTION BY ITEMIZERS

[Comparison of tax years 1981–82]

	Numbers of returns with contributions deductions			Amount (in thousands)			Average contribution per return		
	1981	1982	Percent change	1981	1982	Percent change	1981	1982	Percent change
Total	28,995,858	30,759,612	+6.1	30,800,722	33,498,098	+8.8	1,062	1,089	+2.5
Under $10,000	1,402,426	1,640,315	+17.0	825,655	938,207	+13.6	$589	$572	−2.9
$10,000 to $15,000	2,175,576	2,360,085	+8.5	1,445,121	1,538,666	+9.6	664	671	+1.1
$15,000 to $30,000	11,333,138	11,495,234	+1.4	7,695,924	8,336,285	+8.3	679	725	+6.8
$30,000 to $50,000	10,331,352	11,066,364	+7.1	9,495,148	10,496,116	+10.5	919	948	+3.2
$50,000 to $100,000	3,136,016	3,501,855	+11.7	5,503,085	6,130,777	+11.4	1,754	1,751	−0.2
$100,000 to $200,000	485,159	533,274	+10.0	2,352,371	2,441,545	+3.8	4,849	4,578	−5.6
$200,000 to $500,000	112,822	134,665	+19.4	1,681,088	1,642,844	−2.3	14,900	12,199	−18.1
$500,000 to $1,000,000	14,264	19,658	+37.8	731,573	716,247	−2.1	51,288	36,435	−30.0
Over $1,000,000	5,105	8,162	+60.0	1,070,756	1,212,410	+13.2	209,747	148,543	−29.2

Note.—All figures based on samples. Figures presented at Feb. 22, 1984, meeting of President's Committee on the Arts and Humanities. Data prepared by independent sector, 1828 L Street N.W., Washington, D.C.

STATEMENT OF JOHN A. MCNEICE, JR., PRESIDENT, COLONIAL TAX-MANAGED TRUST, ON BEHALF OF COLONIAL TAX-MANAGED TRUST, EATON VANCE TAX-MANAGED TRUST, PRUDENTIAL-BACHE TAX-MANAGED UTILITY FUND, AMERICAN BIRTHRIGHT TRUST, AND TAX-MANAGED FUND FOR UTILITY SHARES

Mr. Chairman and members of the committee, I am John A. McNeice, Jr., President and a Trustee of Colonial Tax-Managed Trust. We appreciate the opportunity to submit a written statement to the Committee to express our views regarding two specific tax proposals submitted by the Administration in support of its fiscal year 1985 budget.

This statement is submitted on behalf of Colonial Tax-Managed Trust, Eaton Vance Tax-Managed Trust, Prudential-Bache Tax-Managed Utility Fund, American Birthright Trust and Tax-Managed Fund for Utility Shares, all of which are publicly held registered management investment companies which have been taxed as ordinary corporations under the federal income tax law. These mutual funds have a total of approximately 85,000 shareholders and the average shareholder account has a value of approximately $16,000. Many of these shareholders are elderly and retired persons. None of these publicly held funds is controlled by a small group of shareholders.

An investor who buys shares in any of these mutual funds makes a "growth stock" form of long-term investment similar to shares of an operating company, such as Teledyne or Digital Equipment Corporation, none of which distribute cash dividends to their shareholders. Investors purchase shares of such growth companies and the five mutual funds not for current income but with the hope of eventually selling their shares at a profit.

Our comments are directed solely to the proposal to apply to accumulated earnings tax to publicly held companies and to the proposal to repeal the deduction for net capital losses in computing such tax for "mere holding or investment companies."

I. The administration's proposal to apply the accumulated earnings tax to publicly held companies

The Administration has proposed that the accumulated earnings tax provisions be amended to make "clear" that the fact that a company is widely held will not exempt it from the accumulated earnings tax. Joint Committee on Taxation's Proposals Relating to Tax Shelters and Other Tax-Motivated Transactions dated February 17, 1984. We submit that under the existing law, it is "clear" that the tax has been applied only to those publicly held companies which are controlled by a relatively small group of shareholders.

When Congress revised the accumulated earnings tax provisions in the course of their enactment of the 1954 Code, the House bill included a provision which would have excepted from the application of the tax any company which had more than 1,500 shareholders if no more than 10% of the stock was held by or attributable to any individual. H. Rep. No. 1337, 83d Cong., 2d Sess. 54 (1954). The House as apparently attempting to codify existing case law, under which the tax had never been applied to publicly held corporations which were not controlled by a relatively small group of shareholders.[1] This provision was deleted by the Senate Finance Committee as unnecessary because it would be too complicated to administer and the tax was not then "in practice applied to publicly held corporations." S. Rep. No. 1622, 83d Cong. 2d Sess. 69 (1954). This Senate Finance Committee report was cited by Mr. Justice Harlan in his concurring and dissenting opinion in *U.S. v. Donruss,* 393 U.S. 297 (1969), who stated, "In practice, the accumulated earnings provisions are applied *only to closely-held corporations controlled by relatively few shareholders.*" (Emphasis supplied.)

Relying on this legislative history, the Court of Appeals for the Ninth Circuit, following and citing *Donruss,* held that the accumulated earnings tax is inapplicable to publicly held companies. *Golconda Mining Corp. v. Commissioner,* 507 F.2d 594 (9th Cir. 1972). The Internal Revenue Service has disagreed with *Golconda* by stating that there is no legal impediment to applying the accumulated earnings tax to a publicly held corporation. See Rev. Rul. 75-305, 1975-2 C.B. 228.

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[1] The only publicly held corporations to which a court had applied the tax prior to that time was a corporation dominated by a small controlling group of shareholders. *Trico Products Corp. v. Commissioner,* 46 BTA 36 (1934), *aff'd.* 137 F.2d 424 (2nd Cir. 1943), *cert.* denied 320 U.S. 799. The courts have continued to apply the tax to publicly held corporations controlled by a small group of shareholders. *Firstco, Inc. v. United States,* 430 F. Supp. 1193 (D. Mass. 1977) *aff'd per curiam,* 607 F.2d 704 (5th Cir. 1980).

If the IRS's position were codified, *any* publicly held corporation which failed to distribute its earnings in an amount sufficient to satisfy the Internal Revenue Service would be vulnerable to attack. There are many large corporations, the shares of which are widely held, which pay little or no dividends and are accumulating their earnings. These corporations may be faced with the intolerable burden of justifying to the IRS their business decisions to accumulate earnings. Enactment of the Administration's proposal would represent a major substantive change in tax policy affecting thousands of publicly held companies and millions of shareholders which should not be made without careful consideration of all of the ramifications.

We respectfully urge that the Committee take no action on this proposal unless and until the Committee has had an opportunity to consider carefully all of the implications and complications that could result from its enactment.

If, notwithstanding our views, the Committee proceeds with revisions to the tax, we would respectfully propose that:

A. If the accumulated earnings tax is to apply to any publicly held companies, it would apply to such a company only if the company is controlled by a small group of shareholders, consistent with the views of the Congress, the Supreme Court and Ninth Circuit Court, and all judicial decisions to date.

B. If the tax is to apply to any publicly held companies by a statute enacted in 1984, then the application of such tax should be made effective with respect to the taxable years of a company commencing only after December 31, 1985. This will give such publicly held companies and their managements a fair "breathing spell" to adjust to the new law.

C. The statute should contain language barring assessments of the tax against *all* publicly held companies in respect to tax years ending prior to january 1, 1986. This would reflect the fact that Congress has enacted a substantive change in the law, reversing long and clearly established tax law on this point.

II. The administration's proposal to repeal the deduction for net capital losses in computing the accumulated earnings tax for "mere holding and investment companies"

The Administration has proposed that the provision in the law which permits a corporation to deduct its net capital losses in computing its accumulated taxable income be repealed insofar as "mere holding or investment companies" are concerned. In its General Explanations for the Revenue Proposals Contained in the Administration's Fiscal Year 1985 Budget dated February 17, 1984, the Treasury Department has stated that the deduction for net capital losses was introduced in 1936 and that "presumably the purpose of the deduction was to permit a corporation to accumulate income in order to restore capital losses suffered in the course of its business."

The purpose of the 1936 changes to the accumulated earnings tax provisions is clearly set forth in the Senate Finance Committee Report. (S. Rept. 2156, 74th Cong., 2d Sess.) The Revenue Act of 1936 made the tax applicable to "earnings or profits" as opposed to "gains or profits," because the phrase "earnings or profits" describes the fund out of which taxable dividends are paid. In addition, the 1936 Act set forth specific deductions—including the deduction for net capital losses—to be used in determining the measure of the tax. The Senate Finance Committee stated that "One general effect of the changes is to strengthen the section by reasonable deductions in determining the retained net income subject to the tax so that the tax will not be thought to be arbitrary by the courts and their disposition will be to give effect to its provisions." (Emphasis added.) We submit that it is clear that Congress added the deduction for net capital losses in 1936 to ensure that the law conforms to economic reality and that the tax will be less vulnerable to attack in the courts and not, as the Treasury has suggested, to permit a corporation to "restore capital losses" incurred by it.

A net capital loss is a true economic loss for any corporation, including these five mutual funds, and reduces the ability of the corporation to make distributions to its shareholders. Therefore, a net capital loss has always been allowed as a deduction in determining a corporation's earnings and profits, for the obvious reason that a net capital loss cannot be the source of any taxable corporate distribution.

The Treasury goes on to assert in its General Explanations that "While there may have been ample justification for the deduction in 1936, there is little justification remaining today." This is a remarkable statement in view of the fact that a net capital loss has the same effect on earnings and profits in 1984 as it did in 1936.

The accumulated earnings tax is to be applied only to corporations which accumulate "earnings and profits" for the purpose of avoiding income tax with respect to their shareholders. See IRC Section 532(a). There is judicial authority for the proposition that the accumulated earnings tax can apply only if a corporation has earnings and profits for the current year[2] or accumulations of earnings and profits from prior years.[3] We are unable to discover any case or other instance in which the accumulated earnings tax has been applied to a corporation which has neither accumulated nor current earnings and profits. Therefore, in view of the interdependence of the concept of earnings and profits and the applicability of the accumulated earnings tax, we strongly urge that piecemeal changes in one cannot be made without affecting the other. Thus no such changes should be made unless careful consideration has been given to the overall effect.

Furthermore, if and when the entire concept of earnings and profits as the source of taxable corporate distributions is reviewed by the Congress, that will be the proper time to review the appropriate deductions allowable in computing the accumulated earnings tax.

In any event, we believe that a proposal which would impose a penalty tax on a corporation that failed to distribute dividends in a year in which it operated at a deficit is unfair. To illustrate this unfairness, consider the case of a corporation affected by the proposal which has no accumulated earnings and profits and has, for the current year, $1,000 of dividend or interest income and a $2,000 net capital loss. Such corporation has suffered an actual accounting loss for the year of $1,000. Under the Administration's proposal, such corporation could be subject to a tax of up to $385 because it failed to distribute $1,000 in a loss year.

Harsh results of this sort represent unsound tax policy which should be rejected by the Committee.

SUMMARY AND RECOMMENDATIONS

The proposal to make the accumulated earnings tax applicable to publicly held companies to which the tax has never been applied will adversely affect thousands of publicly held companies, and the proposal to repeal the net capital loss deduction in computing the tax for certain corporate taxpayers is inconsistent with economic reality and is arbitrary and unfair.

It is therefore recommended that the Committee sever these two proposals from any tax legislation to be considered in 1984 as both proposals, while simple on their face, would have far-reaching complications and, we believe, undesirable and unfair consequences.

JOINT STATEMENT OF JAMES E. MERRITT, COUNSEL, AND HOWARD A. YOUNG, DIRECTOR OF TAXES, ON BEHALF OF CONSOLIDATED FREIGHTWAYS, INC.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Congress should not change the rules for accrual tax accounting from the "all events" test to the proposed "economic performance" test. As the Administration's proposal relates to accrual of worker's compensation liabilities it is an improper matching of income and expense and unfair to taxpayers by requiring them to pay tax on more than their net income.

If changes are made, accrual of worker's compensation for payments to be made within five years of the date of injury should be permitted. The effective date of any changes should be for injuries occurring in taxable years beginning after the date of enactment and taxpayers should be granted the normal relief which would be provided under Revenue Procedure 80-51, 1980-2 C.B. 818. Other transition and relief provisions are also appropriate.

Comments

The Administration's proposal to substitute a new and largely undefined "economic performance" test for the long standing and well understood "all events" test of *United States* v. *Anderson,* 269 U.S. 422 (1926) and Treas. Regs. § 1.461-1(a)(2) should be rejected. Tinkering with tax accounting methods on a piecemeal basis is unwise and unwarranted.

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[2] *GPD, Inc.* v. *Commissioner,* 60 T.C. 480 (1973), *rev'd.* 508 F.2d 1076 (6th Cir. 1975); *American Metal Products Corp.* v. *Commissioner,* 34 T.C. 89 (1960), *nonacq.* on this issue, 1963-2 C.B. 3, *aff'd.* on other issues, 287 F.2d 860 (8th Cir. 1961); *Corporate Investment Co.* v. *Commissioner,* 40 BTA 1156 (1939), *nonacq.* 1940-1 C.B. 6; *W. S. Farish* v. *Commissioner,* 38 BTA 150 (1938), *nonacq.* 1938-1 C.B. 43, *aff'd.* 104 F.2d 833 (5th Cir. 1939).

[3] *GPD, Inc.* v. *Commissioner,* 508 F.2d 1076 (6th Cir. 1975); *Ostendorf-Morris Company* v. *United States,* 70-2 USTC ¶9550 (D. Ohio 1970).

Worker's compensation liabilities are not a tax shelter nor tax motivated abuse.

The amount of weekly or monthly payments are required by state law.

State law prohibits unauthorized lump sum settlements thus unlike a "structured settlement" the taxpayer does not have an option to pay now or later.

Periodic benefits are required to compensate injured workers and to ensure a steady stream of income.

Over 85% of worker's compensation liabilities are paid within four years.

Present law requires accrual of worker's compensation in the year the injury occurs. *Kaiser Steel Corp.* v. *United States,* 717 F.2d 1304 (9th Cir. 1983); *Wien Consolidated Airlines, Inc.* v. *Commissioner,* 528 F.2d 735 (9th Cir. 1976); *Crescent Wharf & Warehouse Co.* v. *Commissioner,* 518 F.2d 772 (9th Cir. 1975).

Contested claims are not accrued.

Contingent liabilities are not accrued.

Accrued liabilities must be determined with reasonable accuracy.

The proposal regarding deduction of worker's compensation expenses requires taxpayers to accrue income but to deduct expenses only under the cash method.

It would be unfair because it does not properly match expenses with income earned by the services of the injured worker.

Proper matching of worker's compensation expenses with income earned requires that deductions be taken in the year of injury as the courts have held.

Internal Revenue Service positions are more favorable than the Administration's proposals.

Accrual of benefits upon entry of a state award is required. Rev. Rul. 69-429, 1969-2 C.B. 108.

Accrual of medical expenses upon rendering services is required. Rev. Rul. 80-191, 1980-2 C.B. 168.

Accrual of disability benefits upon the period of disability is required. Rev. Rul. 70-262, 1970-1 C.B. 122.

Deduction of amounts paid to a Section 461(f) trust, to a state agency or to purchase an annuity are permitted.

None of these deductions or accrual of expenses presently allowed or required by the Internal Revenue Service would be permitted under the Administration's proposal.

Whatever benefit is obtained from the time-value-of-money from accrual of worker's compensation liabilities is minimal because accruals and payments are currently made.

There will be little revenue gain and probably a revenue loss from the worker's compensation proposal because taxpayers will shift to purchasing insurance.

STATEMENT

Mr. Chairman and members of the committee, we appreciate the opportunity to appear before the Committee on behalf of Consolidated Freightways, Inc. I am James E. Merritt, a partner in the Washington, D.C. office of the law firm of Morrison & Foerster. I accompany Mr. Howard A. Young, Director of Taxes for Consolidated Freightways, Inc. We present this written statement in lieu of a personal appearance and we request that it be included in the record of these hearings.

Consolidated Freightways, Inc. is one of the largest motor common carriers and air frieght forwarders in the United States. It employs approximately 18,000 persons and operates in all 50 states, the District of Columbia and Canada.

Consolidated reports its taxable income and expenses under the accrual method of tax accounting. Section 446(c)(2) of the Internal Revenue Code of 1954 ("Code"). Consolidated has accrued its liabilities for worker's compensation consistently since 1970 in accordance with present law. Generally, Consolidated accrues and deducts its liabilities for worker's compensation in the year an employee is injured. No accrual is made for any contingent or contested liabilities. A deduction is taken for contingent or contested liabilities only when an amount is paid, the contingency is removed, or the contest is resolved. The amounts of the liabilities accrued are computed with reasonable accuracy.

The subject before this Committee "Administration and Other Proposals Concerning Tax Shelters, Accounting Abuses, and Corporate and Securities Reform" involves issues of great importance to our income tax system. As you know, the Administration's accounting and time-value-of-money proposals would require fundamental changes in the system of tax accounting. Our comments focus on the Administration's proposal to change the well established "all events" test for accrual of deductions to a new so-called "economic performance" test which in some instances is simply the cash method of accounting. This proposal is based upon the Treasury's perception that current deduction of liabilities to be paid in the future produces unintended benefits for taxpayers and upon its concern regarding so-called "reserve accounting" methods.

The Administration's proposals raise issues of basic fairness and undermine the net income taxation principle that expenses incurred are to be matched with income earned. Moreover, the proposal fails to distinguish between abusive misuse of the accrual principle, such as in the case of some tax-shelter research and development partnerships, and the proper use by many of this country's leading businesses of a method of accounting which accurately reflects their liabilities to their workers and others. We believe that any overhaul of basic tax accounting principles should be done only with great effort and care, and particularly that tinkering with the basic principles of tax accrual accounting should not be done on a piecemeal basis.

Our comments are specifically directed to the accrual of worker's compensation liabilities. We submit that:

(1) Worker's compensation liabilities are normal business expenses which are not tax shelters or tax motivated transactions;

(2) Worker's compensation liabilities are required, regularly recurring, small payments which are basically different from structured settlements, and decommissioning or reclamation expenses;

(3) Current case law permitting accrual of worker's compensation liabilities is correct and provides adequate safeguards against abuse;

(4) The hypothetical assumptions underlying the time value of money proposals do not reflect actual business experiences and the Treasury's proposals would impose an unwarranted detriment upon normal business taxpayers, both large and small;

(5) The Treasury proposals overstate income by requiring income to be accrued but denying deductions until expenses are paid, violating the basic rule of tax accrual accounting which matches income earned with the expenses generating that income; and

(6) Further study should be made of alternative proposals.

We also submit detailed recommendations regarding effective date provisions and transition rules.

Description of worker's compensation

Law and operations

Under state law each employer must pay worker's compensation to employees or their survivors who are injured or killed in the course of their employment. These mandatory State laws prescribe the amounts to be paid for injuries and the terms of payment. For example, if a worker suffers an injury which prevents him from returning to work for two months, state law requires the employer to pay temporary disability benefits to that worker each week. The amount of the weekly payments is fixed by state law and the dates of payment are similarly prescribed. The employer does not have the option of making a lump sum payment to discharge his liability. The states require employers to provide security for payment of worker's compensation either by furnishing proof of insurance or satisfactory security to operate as a self-insurer.

The clear and worthwhile purpose of worker's compensation laws is to provide the certainty that our working men and women will receive fair compensation when accidents or injuries occur during their employment which require medical attention or hospitalization, or which prevent them from continuing to work, or result in the loss of life or irreparable harm to their body. *By no stretch of anyone's imagination can worker's compensation liabilities be considered to be "tax shelters" or "tax-motivated transactions."* To the contrary, worker's compensation insurance or self-insurance is required to conduct business operations and the expenses are normal, recurring business expenses.

Consolidated has its own claims department in Portland, Oregon for processing worker's compensation claims. It is self-insured for worker's compensation liabilities in 33 states, purchases insurance for such liabilities in 13 additional states, and administers claims via state agencies in four states. In those states in which Consolidated is insured it deducts the insurance premiums paid to the insurance company on the accrual basis for the period of the policy coverage. Consolidated's claims department processes all claims including those arising in states where it is insured.

Consolidated's financial reserves for worker's compensation liabilities have historically been determined as a percentage of payroll costs and included reserves for unfiled and unreported claims and for unspecified contingencies. By comparison, Consolidated accrues its liabilities for worker's compensation in computing taxable income only for each individual filed claim. Liabilities upon such claims which are contingent or contested are not included. Therefore, the amount of Consolidated's financial reserves for worker's compensation liabilities greatly exceed, by approximately 60%, the liabilities accrued in computing taxable income. The difference between Consolidated's financial reserves for worker's compensation liabilities and the amount it accrues for such liabilities in computing taxable income demonstrates that the tax deductions are much, much more limited than financial accounting requirements and dispells the view that tax accrual of worker's compensation under present law is similar to the reserve method of accounting rejected by Congress with the repeal of Section 462 in 1955. P.L. 84-74, 69 Stat. 155 (1955). Suggestions to the contrary in recent testimony before the Committee on Ways and Means by the Assistant Secretary of the Treasury for Tax Policy are, with all due respect, incorrect. *See* Statement of John E. Chapoton Before the Committee on Ways and Means, February 22, 1984, pp. 4-5.

Typical worker's compensation liabilities

It is most important that you understand the nature of liabilities for worker's compensation. There are several types of liabilities which vary substantially.

(1) The most tragic and significant liabilities are for the death of an employee (death benefits). In that event, an employee is liable for payments of a fixed amount to the surviving spouse and children in addition to payments for medical, hospital and funeral expenses. State laws vary but the typical liabilities to surviving spouses are a fixed amount paid each month for life which terminates upon remarriage. Many states require payments of benefits to a surviving spouse for a fixed number of years even after remarriage. The amount of the monthly payments is established by state law and based upon the salary and/or years of employment of the deceased employee. It may be subject to upward adjustment for inflation and other factors.

A typical worker's compensation case involving death benefits is as follows:

In December 1983, Mr. Jones is killed in the course of his employment. He is survived by his widow, age 32, and three minor children ages 2, 4, and 8. Under the laws of State X, the widow is entitled to receive worker's compensation benefits of $350 per month for the rest of her life unless she remarries. If she remarries she is entitled to receive benefits for two years, which may be payable to her estate if she dies prior to the end of the second year. Each minor child is entitled to receive worker's compensation benefits of $100 per month until they reach age 18.

The liabilities to Mr. Jones' survivors fixed under State law are as follows: Widow (72 year life expectancy), $168,000; 2-year-old child, $19,200; 4-year-old child, $16,800; and 8-year-old child, $12,000.

Of the $168,000 liability to the widow only $8,400 is accrued because the portion in excess of two years is contingent upon her failure to remarry. The total financial reserve established for this claim is $216,000, of which only $56,400 is accrued in computing taxable income. It should be noted that the employer does not have the option to make lump sum payments to the widow and minor children. State law requires monthly payments. The purpose of State worker's compensation benefit payments to survivors is to insure a steady stream of income. Lump sum settlements can only be made upon approval of State agencies and ususally only upon a showing of hardship.

(2) The least serious liabilities, although substantial in aggregate dollar amount, are for medical and hospital expenses for injuries which do not result in any disability ("medical only" benefits). Upon the occurrence of any injury to an employee a report is prepared and medical care is obtained or recommended. Medical only claims are usually relatively small in amount and paid within a short period after the injury occurs. Consolidated has substantially reduced the number of "medical only" claims within the last three years by providing more first aid treatment on the job.

(3) Injuries which result in full or partial temporary disabilities create liabilities for worker's compensation for such disability in addition to medical and hospital expenses. During the period the employee is unable to perform his normal duties the employer must make weekly payments of worker's compensation. The amounts are prescribed by State law based upon the degree of disability (seriousness of the injury) and/or the salary and experience level of the injured employee. The period of temprary disability is determined to end when a doctor certifies the employee can return to work or that the disability has become permanent. The vast majority (75 percent to 80 percent) of temporary disability payments are completed within six weeks. Temporary disabilities which last longer than six weeks may require payments for up to one to two years.

(4) Employees also suffer injuries which leave them permanently disabled either partially or totally. Such injuries create liabilities for worker's compensation in addition to medical and hospital expenses. These liabilities are similar to temporary

disability liabilities although of longer duration and greater amount. The amount is prescribed by State law based upon the degree of disability and/or the salary and experience of the injured employee. States may require that these liabilities be resolved by lump-sum payments in case of hardship and such settlements may only be negotiated in other cases subject to review by State agencies. In addition, liability for retraining or rehabilitation expenses may be incurred because of such injuries.

A typical temporary disability case which becomes a permanent disability is as follows:

Mr. Smith is struck on the shoulder and back by a heavy crate. He cannot move his right arm and shoulder and complains of back pain. He is immediately taken to a hospital and placed under a doctor's care. The doctor says that Mr. Smith will not be able to return to work for 4 weeks and that he will undergo treatments, X-rays, etc. during that period. At this point, liabilities are accrued for the medical and hospital expenses of $800 and for 4 weeks temporary total disability of $600 ($150 per week).

At the end of the third week, the doctor advises that Mr. Smith will not be able to return to work for an additional 8 weeks and that additional treatment is required. Additional amounts are accrued for medical expenses and 8 weeks temporary disability payments, $1,200.

After Mr. Smith has been on temporary disability for 10 weeks he claims that he is permanently disabled and cannot return to work. Consolidated requests a report from his doctor and also requests that a second medical opinion be obtained. Mr. Smith's doctor reports that Mr. Smith is indeed permanently disabled. (He is age 50 and his life expectancy is 70.) The second doctor confirms that Mr. Smith is unable to return to work for an additional 4 weeks but concludes that Mr. Smith is not permanently disabled. Based upon these new facts, additional medical expenses and additional temporatry disability liabilities may be accrued. An amount is determined for the claim of permenant disability which is included in financial reserves, but it is not accrued because such amount is contested. Later both doctors and the company agree that Mr. Smith is permanently disabled and the contest is resolved. At this point permanent disability liability of $200 per week for his 20 year life expectance (for a total of $208,000) is accrued.

This liability requires weekly payments of $200 per week for 20 years. The present discounted value of those payments is $119,870 at a discount rate of 5.94%. The difference (or perhaps, more properly, only the tax savings thereon) is an amount which the Administration considers to be a "windfall" to the taxpayer. The proposal to restrict deductions to the cash method would permit deduction of only a maximum of $10,400 in the year the injury occurred and, thus overstate income in that year by $197,600 on the full face value basis or $109,470 on a discounted present value basis. The result of the Administration's cash method proposal would thereby result in a "windfall" to the Treasury by comparision to any proper matching of expenses of the period with income earned from such activities during the period.

An important further point is that some states require the employer to pay an amount to the state to provide for payment of permanent disability benefits to the employee. The amount paid is a discounted amount although the exact formula is not disclosed by the state agency. The Administration's proposal would deny deduction for that payment by the employer because the liability to the claimant (now from the state not the employer) is not extinguished. That is clearly an unfair and improper result.

Determination of amount of accrued liability

Consolidated employs a staff of 10 expert worker's compensation examiners. Most have substantial experience in the insurance industry. The examiners specialize in laws of specific states and are thoroughly familiar with medical terminology. Reports of injuries and claims for benefits are immediately provided to the examiners together with any invoices for services or treatment rendered. Based upon the nature of the injury and the laws of the state of jurisdiction, the liability for the injury is determined. Liabilities contingent upon remarriage of a surviving spouse and liabilities which are contested are separately noted and no accrual is made for such amounts although financial reserves are established for such liabilities.

It is important to understand that determination of the amount of workers's compensation liability is not a static process. As additional information is obtained, the claim file is reviewed and the amount of liability may be increased or decreased. Upon receipt of a claim or an injury report an examiner is able to determine the liability for the initially required medical treatment and whether the employee will be unable to return to work immediately. The latter fact determines liability for temporary disability payments. (In all but a few cases, it is easy to determine whether there is liability for the injury. In those few caes, the fact of the employer's liability is contested and because it is contested no amount is accrued in determining taxable income, although an amount may be set aside in financial reserves.) Immediately following receipt of the injury report, a medical examination is conducted and a report obtained from a doctor. This report specified the medical treatment required and the time when the employee will be able to return to work. Based on this report, the amount of liabilities may be increased or decreased and the period of temporary disability may be redetermined and adjustments made to the accrual. Similar medical examinations and reports continue to be received throughout the period of a claim and appropriate adjustments are made on the basis of such examinations and reports. Additional adjustments are made based upon invoices received and payments for services if they vary from the medical reports.

All claims are reviewed by Consolidated's staff on a quarterly basis and at the end of the year. The year end review is particularly meticulous because it is the basis for tax accruals. Large or complex claims are also reviewed by an expert committee of specialists in claims and employee benefits. Mr. Young is one of the members of that review committee.

The amounts of liabilities including the amounts accrued in computing taxable income are regularly audited by Consolidated's internal audit staff and Consolidated's independent public accounting firm.

Thus, an accrual for worker's compensation liability is not establishing a fixed amount upon occurrence of the injury which is unchanged, but establishing amounts based upon new facts and the best information available which is updated on a continuous basis to insure the accuracy of the accrual. A test of accuracy based upon a comparison of the initial amount accrued to the total amount ultimately paid will almost invariably show that less was accrued than paid. The amounts paid based upon the medical treatment required and disability established based on the initial reports will, however, be extremely accurate. The process of establishing an accrued liability and adjusting the amount as additional facts are obtained is squarely within the tax accrual accounting method established in Treasury Regulations § 1.461-1(a) which provides as follows:

"Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy.

While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, *the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy.* For example, A renders services to Be during the taxable year for which A claims $10,000. B admits the liability to A for $5,000 but contests the remainder. B may accrue only $5,000 as an expense for the taxable year in which the services were rendered. In the case of certain contested liabilities in respect of which a taxpayer transfers money or other property to provide for the satisfaction of the contested liability, see § 1.461-2. *Where a deduction is properly accrued on the basis of a computation made with reasonable accuracy and the exact amount is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account for the later taxable year in which such determination is made.* (Emphasis supplied.)

A comparison of the method of accruing liabilities for worker's compensation previously described with the requirements of the Regulations makes it clear, as the courts have held, that it is squarely within the rules of accrual tax accounting.

In summary, worker's compensation expenses do not involve large lump sum payments of uncertain amounts at some uncertain time in the future. Worker's compensation expenses consist of: (1) medical and hospitalization expenses paid currently (within months of the accrual of the liability); (2) temporary disability benefits paid weekly and discharged in full in 70% to 75% of the cases within six weeks with the remainder discharged within one to two years; and (3) permanent disability benefits and death benefits to survivors paid on a monthly basis. It is only the last category which involves any significant future payments. Approximately 85% of all worker's compensation expenses are paid within four years from the date of injury. Of the remaining 15%, deductions may not have been claimed at the time of injury because the liability was contingent (payments to surviving widows contingent upon failure to remarry) or contested. Once these facts are understood, we believe it clear that there is no significantly measurable benefit from the time-value-of-money regarding worker's compensation which warrants repeal of the "all events" test.

Taxation of worker's compensation liabilities under present law

A business subject to worker's compensation liability under state law must provide for satisfaction of that liability either by contracting with a worker's compensation insurance carrier, by establishing a qualified self-insurance program (under which the business itself will pay any liability imposed on it under the applicable state laws), or by a combination of insurance and self-insurance. The Administration's proposals only affect taxpayers who are self-insured and report taxable income upon the accrual method.

Deduction of expenses under the accrual method is proper when (1) all of the events that bear on the fact of liability have occurred and (2) the amount of liability has been determined with reasonable accuracy. *United States* v. *Anderson,* 269 U.S. 422 (1926); Regs. § 1.461-1(a)(2)(1983). There has been significant controversy regarding the types of worker's compensation liabilities which may be accrued and deducted under this two-pronged test. Nevertheless, under the prevailing interpretation of the law, a carefully administered system of accruing worker's compensation liability in cases where the fact of the employer's liability is uncontested satisfies both prongs of the test.

The Internal Revenue Service has long contended that most worker's compensation liabilities do not satisfy either prong of the *Anderson* test. However, the Service has agreed that taxpayers may accrue worker's compensation liabilities established by an award in the year of the award. Rev. Rul. 69-429, 1969-2 C.B. 108. The Service has viewed events occurring after an employee's death or injury as "contingencies" upon which the employer's liability depended. For example, the Service has contended that liability for medical care is not established until after such care has been provided (Rev. Rul. 80-191, 1980-2 C.B. 168) and that an employer's liability to make payments until their nineteenth birthday to children surviving a deceased employee was not established because the children could die earlier (Rev. Rul. 70-262, 1970-1 C.B. 122). Initially, some judges of the Tax Court accepted the Service's arguments. *Thriftimart, Inc.* v. *Commissioner,* 59 T.C. 598 (1973); *Crescent Wharf & Warehouse Co.* v. *Commissioner,* 59 T.C. 751 (1973), *rev'd* 518 F.2d 772 (9th Cir. 1975).

Almost simultaneously with the *Crescent Wharf & Warehouse* decision, another Tax Court decision reached an opposite conclusion, permitting accrual of liabilities to surviving children of a deceased worker on the ground that the employee's death established the fact of the employer's liability to the children. *Wien Consolidated Airlines, Inc.* v. *Commissioner,* 60 T.C. 13 (1973), *aff'd* 528 F.2d 735 (9th Cir. 1976). Both cases were appealed to the Ninth Circuit Court of Appeals.

The Ninth Circuit held that accrual was permissible under the "all events" because the fact of injury to an employee in an uncontested case is sufficient to establish the employer's liability. (Deductions for contested liabilities were not claimed until the contest was resolved.) The court found that liability for medical service and loss of time from work was fixed at the moment of injury, and that only the *amount* of the liability was not absolutely certain at the moment of injury. *Crescent Wharf & Warehouse,* 518 F.2d at 774. Likewise, liability to the surviving children of a deceased employee was fixed at the moment of the employee's death and only the amount of that liability would be affected if the children died before their nineteenth birthday. *Wien Consolidated Airlines,* 528 F.2d at 737-38.

As noted above, the "all events" test requires more than a fixed liability as a prerequisite to a deduction. In addition, the amount of the fixed liability must be determined with reasonable accuracy. Thus, a reserve based on a rough estimate of worker's compensation liabilities is not deductible, but a deduction is permitted when the amount of liability, though not determined down to the penny, is determined in a careful, objective manner which results in a reasonably accurate calculation. For example, in *Wien Consolidated Airlines, Inc.* the taxpayer sought to accrue and deduct two types of accrued liability: (1) for payments to children of deceased employees, which would continue until each child's nineteenth birthday or death, whichever came first, and (2) for payments to widows of the employees, which would continue until the earlier of death or remarriage. The Ninth Circuit, noting that there is over 97% chance that an infant in the United States will survive past age 19, approved accrual of the children's benefits on the basis that they would live to reach 19. Noting the absence of any evidence of similar probabilities regarding remarriage of widows, the court refused to allow deduction of an accrual based on life expectancies of the widows because of the contingency that payments would terminate upon remarriage. The first accrual, for benefits to the children, was determined with reasonable accuracy. The second, for benefits to the widows, was not.

Thus, under present law only accruals supported by objective factual determinations are deductible. Where the objective impact of possible later occurrences cannot be reasonably accounted for, deduction of a liability may not be accrued for a fixed liability because the amount of liability cannot be determined with reasonable accuracy.

In short, *Crescent Wharf & Warehouse* and *Wien Consolidated Airlines* established that in a worker's compensation case the employer's liability was fixed at the time of injury, so that accrual of a liability for worker's compensation could be deducted provided that there was a reasonably accurate determination of the amount of the liability. The Service issued Rev. Rul. 80-191, stating that it would not follow these cases. The Service litigated the issue again, and lost again in *Kaiser Steel Corporation* v. *United States,* 717 F.2d 1304 (9th Cir. 1983). The Service has not yet indicated whether it will follow *Kaiser Steel Corporation,* although the government has decided not to seek review of the Ninth Circuit's decision. Despite the Service's position, the courts have approved deductions based on objective calculations of liability where no deduciton is taken for contested or contingent liabilities. A major basis for the courts' opinion has been that the accruals are proper under the Code and Treasury Regulations and that accrual of the liabilities at the time of injury is required to properly match income and expense. As the Ninth Circuit stated in *Crescent Wharf & Warehouse:*

"The most logical correlation of income to expenses would be by deducting in the year the injury was sustained the employer's liability actually paid or which was accrued with reasonable accuracy as arising out of that injury. 518 F.2d at 775."

Present law should not be changed

The present accrual tax accounting rules for worker's compensation and similar liabilities should not be changed in the manner described in the Administration's proposal. The Administration proposes to require employers to use the cash accounting method (labeled an "economic performance" redefinition of the "all events" test) for major expenses, while maintaining an accrual method for reporting income. Far from fairly reflecting the time value of money, the proposal results in an income distortion—with income reported in earlier years (as accrued) and expenses in later years (as paid). If a statutory change in the tax accounting rules is made, it should be to provide clearer statutory authority for accrual of worker's compensation liabilities in the year the injury is incurred consistent with basic principles of matching income and expenses of a period. A proper analysis of worker's compensation expenses is that they are attributable to the services provided by the worker and should be matched with the income earned in the year of the injury. *See* Testimony of Emil M. Sunley, Director of Tax Analysis, Deloitte, Haskins and Sells (Former Deputy Assistant Secretary for Tax Analysis, Department of the Treasury) before the Subcommittee on Oversight of the Committee on Ways and Means on "The Timing and Measurement of Taxpayer Deductions For Obligations to be Paid in the Future" (February 24, 1984). That is precisely the result the courts have reached upon application of the "all events" test.

The cash method proposal goes much too far

At the outset it should be recognized that the Administration's proposal to require accrual method taxpayers to deduct worker's compensation liabilities only when payment is made which extinquishes the liability to the claimant goes much too far. It also goes much further than the position of the Internal Revenue Service in published rulings. Although the Treasury Department calls this accrual of liabilities upon "economic performance," it is clear that their proposal is nothing more or less than to require worker's compensation liabilities to be deducted only on the cash method—when payment is made. "Revenue Proposals contained In The Administration's Fiscal Year 1985 Budget: General Explanations," Department of the Treasury (Feb. 17, 1984), Item D.2.a., p.2. There is no reason why an accrual basis taxpayer should not be permitted to accrue hospital and medical expenses once a statement (invoice) is received or temporary or permanent disability payments once the period of disability has occurred. Such accrual of expenses would be allowed even under the restrictive position argued by the Service. *See* Rul. 80-191, *supra;* Rev. Rul 70-262, *supra.* Under the Administration's proposal taxpayers would not be entitled to accrue deductions for worker's compensation liabilities determined by a state award contrary to the long-standing published position of the Service. Rev. Rul. 69-429, *supra.* Normal accrual rules are proposed for other liabilities. No explanation is given as to why worker's compensation liabilities should be less favored than the other accruals. That is particularly strange because it is the other liabilities which most neatly fit within the Administration's hypothetical example. The failure to allow deductions for accrued expenses for worker's compensation upon the same basis as allowed for coal mine reclamation expenses (when land is reclaimed) and nuclear power plant decommissioning expenses (when the plant is decommissioned) demonstrates the danger of proceeding too hastily without full and fair consideration.

Another point regarding the Administration's proposal to redefine the all events test to require "economic performance" (which in the case of worker's compensation is defined as "when payments are made extinguishing liability to claimants") is that it may prevent deductions when payments are made to an appropriate trust authorized by Section 461(f); to a state agency as required by state law; or to purchase an annuity. Such a result would be extremely unfair because under any procedure the taxpayer has paid the money to a trust sanctioned by the Code; to the state; or to an annuity company to insure that the liabilities are paid. Deductions for such payments would be permitted under current law and the Administration's proposals do not address those issues.

Accrual for worker's compensation liabilities is not a "tax shelter" nor a tax motivated abusive situation

Liabilities for worker's compensation payments arise upon an injury to an employee. *Kaiser Steel Corp.* v. *United States,* 717 F.2d 1304 at 1306–07 (9th Cir. 1983) and *Crescent Wharf & Warehouse Co.* v. *Commissioner,* 518 F.2d 772 at 774 (9th Cir. 1975); *Wien Consolidated Airlines, Inc.* v. *Commissioner,* 528 F.2d 735 at 737–38 (9th Cir. 1976). The amounts of liabilities are prescribed by state laws and are determined with reasonable accuracy. *Id.*

Deputy Assistant Secretary Pearlman lumped worker's compensation liabilities together with structured settlements in his statement before the Subcommittee on Oversight on February 24, 1984. That is not appropriate. Worker's compensation liabilities are far removed from structured settlements in which one taxpayer with a present liability persuades another taxpayer to accept a larger amount payable years in the future. In the typical example of a structured settlement, a taxpayer could settle a liability to a claimant by paying $1,000,000 today. Instead, the taxpayer negotiates an agreement with the claimant to pay him $3,000,000 in 15 years. The taxpayer takes a current deduction for $3,000,000 and earns a profit by investing the tax savings for 15 years. Worker's compensation disability or death benefits are different for several reasons. First, current small amounts (generally $100 to $400) are paid weekly or monthly to the claimant. Second, the taxpayer is prohibited by state law from making an immediate lump sum payment as previously described. Third, the taxpayer is not tax motivated to make periodic payments of worker's compensation benefits whereas in a structured settlement deferral of the payment is tax motivated and may be attacked under *Goldstein* v. *Commissioner,* 364 F.2d 734 (2d Cir. 1965), *cert. denied,* 385 U.S. 1005 (1966).

Worker's compensation liabilities are also different from coal mining reclamation expenses or nuclear powerplant decommissioning expenses in that the injury has occurred at the time of accrual whereas the reclamation or decommissioning has not. In addition, payments have been and continue to be made on a frequent, regular basis upon worker's compensation liabilities beginning at the time of accrual. They are not large, future payments which may never be paid. Instead they are a stream of small regular payments which are being paid weekly or monthly.

Payment of worker's compensation to injured employees is a desired societal goal adopted by all states. It is a valuable and needed social program carried out by the private sector pursuant to state law. The present tax law encourages periodic payments of worker's compensation benefits by properly allowing a deduction for such liabilities in the year the injury occurs. If the Administration's cash basis proposal is adopted, employers must earn much more in the year of injury to fund payment of worker's compensation benefits properly chargeable to that period.

In a troubled or break-even operation, the very ability of employers to make future payments or worker's compensation will be impaired by the proposal. Part of any income which would be set aside to provide for future satisfaction of the liability will have been taken by the government as a premature tax. Thus, in the above example of a disability claim, to pay $10,400 to Mr. Smith in the year following the injury, the employer would ordinarily be expected to set aside in the year of injury the present value of the payment to be made in the following year. However, part of this amount must be paid to the government to satisfy the artificially inflated tax liability. As a result, the employer is left without enough available cash to set aside and earn a return sufficient to satisfy the liability. In the example, the process of premature taxation would consume the fund approximately as follows:

Amount of liability	$10,400
Increase in tax in year of accident resulting from failure to match income and expense (at 46 percent)	4,784
Remainder available for payment	5,616
Return on investment (at 6 percent after tax rate)	337
Amount available to make payment	5,953

Thus, under the Administration's proposal, the taxpayer would be left over $4,000 short of the amount necessary to make the payment.

The Administration would seek to minimize the possibly disastrous consequences of such a tax-induced shortfall by permitting quick refunds of net operating loss carrybacks and by proposing an amendment to the carryback rules to allow losses arising in the year of payment to be carried back more than three years. Unfortunately, this proposal does little to address the disastrous consequences of premature taxation or the underlying unfairness of the Administration's proposal.

First, it should be noted that inclusion of the carryback extension in the proposal is an implicit recognition that the overall proposal results in mismatching of income and expenses. Moreover, it is a recognition of the fact that in many cases the expenses, attributable to income earned in earlier years, would be deferred into a year where there is no income earned to absorb them.

The availability of a net operating loss carryback would not compensate the taxpayer for the use by the government of the tax dollars generated by mismatching of income and expenses. A taxpayer filing a claim for a net operating loss carryback refund is not entitled to interest on the refund for the period between the original payment of the tax and the filing of the net operating loss refund claim. Section 6611(f)(1).

In addition, in a truly critical situation, it is conceivable that the tax-induced shortfall could not be overcome by a quick refund of a net operating loss. First, such a claim cannot be filed until the end of the taxable year in which the payment is made. Section 6411(a). Before then, the taxpayer must find another source of funds or default on its obligation. Second, if the taxpayer cannot afford to make the payment, no deduction for the payment can be taken and the tax-induced shortfall cannot be recovered. While it would certainly be an extreme case in which other funds could not be used to make the payment, the fact that the proposal would force the taxpayer to generate or borrow additional funds illustrates the unfairness of the proposal.

Under present law the service and the courts can control abuses

Unless a taxpayer has already adopted the accrual method for worker's compensation liabilities, it must obtain the consent of the Commissioner to change its method of accounting. Under these procedures, the Commissioner can control the numbers of taxpayers who adopt the accrual method.

The amounts accrued must be capable of computation with reasonable accuracy. Treas. Regs. § 1.461-1(a); *e.g., Kaiser Steel Corp.* v. *United States,* 717 F.2d 1304 at 1308 (9th Cir. 1983). In a recent case involving accrual of worker's compensation, the trial court held accrual was improper because the Commissioner's consent to a change of accounting method had not been obtained and because the amounts were not computed with reasonable accuracy. *ESCO Corp.* v. *United States,* 83-2 U.S.T.C. ¶9714 (D. Ore. 1983).

If a taxpayer should increase the amount of an accrued liability in order to obtain a greater tax deduction, the deduction may be disallowed as not constituting an ordinary and necessary business expense. *E.g., Goldstein* v. *Commissioner,* 364 F.2d 734 (2d Cir. 1965), *cert. denied,* 385 U.S. 1005 (1966).

Finally, deductions have been and can be disallowed if the time for payment is too remote, *Mooney Aircraft, Inc.* v. *United States,* 420 F.2d 400 (5th Cir. 1969), or the amounts accrued might not be paid, *Southern Pacific Transportation Co.* v. *Commissioner,* 75 T.C. 497 (1980); *World Airways, Inc.* v. *Commissioner,* 564 F.2d 886 (9th Cir. 1977), *aff'g* 62 T.C. 786 (1974); *see Burlington Northern Railroad Co.* v. *Commissioner,* 82 T.C. No. 13 (Jan. 24, 1984).

The time value concept is highly complex and hypothetical

Underlying the Administration's time value of money proposals is the concept that taxpayers should only receive the current benefits of a discounted present value deduction of liabilities to make future payments. Indeed a proposal to permit such deductions was considered by the Treasury and Senate Finance Committee. It has now, however, been abandoned because it was too complex. Fairness or unfairness in the tax law should not be determined upon comparison to a result too complex to propose.

Such complexity demonstrates the real life fallacy of the assumed hypothetical example utilized to describe the time value of money proposals. What interest rate should be used? The choice of an interest rate and after tax discount rate will make tremendous differences in the results. Our experience, particularly recently, is that interest rates fluctuate frequently and by extreme factors. Should the computations of deductions or concept of relative fairness or benefit fluctuate on such whims? Can businesses operate on that basis? Of course not.

Another difficulty with the Administration's time value of money concept is that it relies upon examples whereby an amount is accrued and deducted in one year and no payments are made until ten or more years later. Upon such hypothetical facts, it is easy to conclude that there is a benefit to the current deduction and use of the taxes saved over the period before payment is required. Worker's compensation involves a series of accruals over a period of time and regular weekly or monthly payments. Thus, worker's compensation liabilities do not fit neatly within the hypothetical example and, as illustrated previously, the Administration's proposals may cause real hardship where the time between accrual and payment is relatively short. In addition, allegations of time-value-of-money benefits are greatly exaggerated in situations such as worker's compensation liabilities because accruals and payments are being made and most such liabilities are paid within a short period of time.

Perhaps in an ideal world discounted present value computations would be made for each payment made or received whether expense, capital or income. We would then have a perfect accrual accounting system attuned to the time value of money. As Treasury admits, such a system is not workable in the real world. Thus, it should not be used as a standard against which to measure our present tax system. which is designed to collect a fair tax on real income.

The Kaiser Steel Corp. decision

The substantial power the Commissioner has to withhold consent to change a method of accounting and the judicial restrictions described above are sufficient to prevent any abuse of the accrual accounting method for worker's compensation. This leads to the conclusion that the Treasury Department's concern is with the scope of the recent decision in *Kaiser Steel Corporation* v. *United States,* 717 F.2d 1304 (9th Cir. 1983) by comparison with the prior opinion of that same court in *Crescent Wharf and Warehouse Co.* v. *Commissioner,* 518 F.2d 772 (9th Cir. 1975).

First, to the extent the *Kaiser Steel Corporation* opinion can be read to authorize accrual for contingency reserves it does go too far. We do not believe it authorizes any such accrual of contingency reserves. The Ninth Circuit in *Kaiser Steel Corporation* applied the "all events" test of *United States* v. *Anderson,* 269 U.S. 422 (1926) and Treasury Regulations § 1.461-1(a)(2). It did not abandon that test and conceive a new "reserve" accounting method. Contrary to the government's arguments in that case and prior cases, the Ninth Circuit held that the fact which establishes liability is the injury to the employee. Other, subsequent facts, such as the costs of medical treatment and period of disability do not determine the fact of the employer's liability—only the amount of that liability. An accrual of worker's compensation liabilities for each injury suffered and claim made against an employer should be allowed. That is the rule established in *Crescent Wharf and Warehouse Co.*

The *Kaiser Steel Corporation* opinion does state that the reasonable accuracy of the taxpayer's accruals may be judged by comparing the total payments on claims against a taxpayer to the total amounts accrued by the taxpayer. As explained previously, a specific comparison of the initial accrual upon a claim with the total payments on a claim is not meaningful. This is true because frequent adjustments are made to the amount initially accrued on an individual claim based on new facts and information. Thus, the total payments upon a specific claim will correspond precisely to the initial accrual as subsequently adjusted. To measure the accuracy of the accrual at any time in the process of a claim the reasonableness of the accrual can be determined upon an evaluation of the facts then known. Failing such a detailed examination of the status of each claim at a particular point in time, it is entirely appropriate to compare aggregate accruals and aggregate payments and we assume that such comparison was considered by the parties and the courts for convenience.

The previously described difference between the amount of accrual for worker's compensation liabilities and the amount of financial reserves for worker's compensation liabilities makes it clear that accrual of worker's compensation liabilities is not, in fact, a return to a financial reserve method of accounting.

Tax accounting methods should not be changed on a piecemeal basis

It is important to bear in mind that a method of accounting is exactly that—a method. To change one specific item without an examination of the entire method will promote unfair results which will distort income. Full consideration of a tax accounting method which takes into account the time value of money should consider income and capital items as well as selected expense items. A full range of options should also be presented regarding expense items. Thus, depreciation deductions based upon replacement costs should be considered. Such a project may indeed be worthwhile, but we submit that there is a long way to go before any sound conclusions can be reached. *E.g.*, Testimony of James B. Lewis, Paul, Weiss, Wharton & Garrison (Chairman-Elect, American Bar Association, Section of Taxation) and Dennis P. Bedell, Chairman, Tax Committee, American Mining Congress before the Subcommittee on Oversight of the Committee on Ways and Means on "The Timing and Measurement of Taxpayer Deductions for Obligations to be Paid in the Future" (February 24, 1984).

Taxpayers must perceive the Administration's proposals to be unfair. As to worker's compensation liabilities, the Administration's proposals are essentially that the taxpayer must accrue income but may not accrue expenses. This clearly produces a mismatching of income and expenses which any rational accounting method should try to avoid. *See* Aidinoff and Lopata, "Section 461 and Accrual-Method Taxpayers: The Treatment of Liabilities Arising From Obligations to be Performed in the Future," 33 *Tax Lawyer* 789 at 796–97 (1980).

Such a matching principle has been long recognized by the courts. *E.g. United States* v. *Anderson,* 269 U.S. 422 (1926). Indeed, the basic idea of an accrual accounting method is that expenses definitely incurred should be reflected "without regard to whether payment has been made or whether payment is due." *H.H. Brown Co.,* 8 B.T.A. 112, 117 (1927), *acq.,* VII–1 C.B.5. The more restrictive Internal Revenue Service view has been criticized by commentators and rejected by the courts. Aidinoff and Lopata, *supra,* at p. 797–800; *Kaiser Steel Corp.* v. *United States, supra; Crescent Wharf and Warehouse Co.* v. *Commissioner, supra.*

The proposed change will not produce significant new revenues

Although the Administration estimates that its accounting and time-value-of-money proposals will produce in excess of $1.8 billion over three years, very little or none of that increase can be attributed to accrual or worker's compensation liabilities. Indeed the Administration makes no specific estimate of revenue gain from the proposed change to a cash method for deduction of worker's compensation liabilities. If the proposed change is enacted, it would produce some revenue gain if taxpayers continue to operate as they presently do. That, clearly will not be the case because employers who are now self-insured will purchase insurance for all or a portion of their worker's compensation liabilities. Current insurance premium quotations are approximately 40 percent greater than current worker's compensation expenses. Thus, employers will obtain an additional deduction and insurers will receive additional income, but that income will be reduced by insurance reserves for worker's compensation liabilities which will be as great or greater than the amounts presently accrued as deductions. *The result is more likely a revenue loss instead of a revenue gain.*

If employers cannot accrue worker's compensation liabilities, but insurance companies can, an unfair distinction will be created between insured and self-insured coverage. The amount deducted for future payment of worker's compensation claims by insurance companies is as great or greater than that deducted by self-insureds under present law. The annual expense (or income which must be earned to fund worker's compensation) is too great to bear without a tax deduction. As a result many taxpayers will shift to insurance in whole or in part. This is an unwarranted and undesirable result because self-insured employers are frequently more safety conscious, more responsive to employee needs and less expensive.

If present law is changed alternatives to the current proposal should be considered

Accrual of discounted present value

The Administration has considered, but not presented, an election to accrue the discounted present value of future payments. We suspect it was abandoned because it is less favorable to taxpayers than the cash method and because the complexity of required adjustments reflecting real life situations would demonstrate conclusively the unfairness of the proposal. The concept, however, is the Administration's standard for determining the fairness of present tax results. For that reason, we believe that this Subcommittee should examine this proposal and the Administration's prior efforts. Under such a proposal, the discount rate should be an after tax rate and should be the stated interest rate in Section 6621 times 100% less the maximum stated tax rate, currently 46% for corporate taxpayers. At present the proper after tax discount rate would be 5.94% (11% interest rate times 54%, *i.e.* 100% less the 46% tax rate). Lest this be considered a simple and obvious method of accounting for the time value of money, it should be noted that the potential problems with such a rule are substantial. It is a harsh rule which does not permit taxpayers to deduct the full face value of their expenses nor is it clear what result would follow if future payments were increased because of inflation, etc. *See* Aidinoff and Lopata, "Section 461 and Accrual Method Taxation: The Treatment of Liabilities Arising from Obligations to be Performed in the Future," 33 Tax Lawyer 789 (1980).

Amend section 501(c)(9)

Another alternative the Subcommittee may consider is to amend Section 501(c)(9) to permit taxpayers to pay funds into a trust to provide for payment of future worker's compensation liabilities. Presumably the amounts paid into the trust would be the discounted present value of future claims plus the full amount of claims to be paid within the near future, for example five years. Amounts withdrawn from the trust by the employer, if any, would be taxable income in the year received.

Adopt an arbitrary time period

Another proposal considered by the Administration and others is to adopt an arbitrary time period for the accrual of future payments. *See* New York City Bar Report, "Transactions Involving Deferred Payment of Accrued Liabilities: Federal Income Tax and The Time Value of Money," 20 *Tax Notes* 699, at 714 (Aug. 29, 1983). If such an approach is adopted the proper period should be carefully considered. A more appropriate period than the one year period previously considered would appear to be five years.

Permission to change to the cash method

If the Treasury Department's proposal to require accrual method taxpayers to report worker's compensation liabilities and similar liabilities only when claims are paid (*i.e.*, the cash method) is adopted all affected taxpayers should be authorized to elect to report all income and expenses on the cash method within prescribed time limits.

Transition Rules

Effective date

It is recommended that any changes be effective for injuries occurring in taxable years beginning after December 31, 1984 (or the end of the calendar year in which changes are enacted, whichever is later). The effective date should apply to injuries occurring after a certain point in time. Under present law, it is the date of injury which fixes the time for accrual. Obviously, the required changes in accruals could be made most efficiently at the end of an employer's taxable year. Under this approach, a calendar year taxpayer would continue to report under present law for its taxable year ended December 31, 1984 and would apply the changed rule beginning January 1, 1985. A July1-June 30 fiscal year taxpayer would continue to report under present law for its taxable year ended June 30, 1985 and would implement any changes thereafter. If amendments are not enacted in 1984 the effective date provision would operate following the end of the calendar year of enactment. This recognizes the need for advance notice to taxpayers and the fact that accrual of worker's compensation liabilities is not a tax shelter nor a tax motivated transaction. It is unreasonable to expect that employees are going to suffer injuries simply to take advantage of a future effective date.

Present law continues to apply to prior injuries

Injuries occurring prior to the effective date should continue to be subject to present law. This should include subsequent adjustments to the accrued liability as additional or new information is obtained. Thus, injuries occurring prior to the effective date would continue to be reported as accrued liabilities after the effective date including increases or decreases in the accrued amount.

Section 481 adjustment for cash method

In the event that the Administration's proposal to require employers to report their liabilities for worker's compensation under the cash method of accounting is enacted the normal relief furnished to taxpayer's forced to change their method of accounting should be provided. Section 481. In this case, under Section 481, the taxpayer would begin to deduct worker's compensation liabilities upon payment as of the beginning of the taxable year in which the change is effective. The taxpayer would deduct *all* payments, including those related to claims previously accrued. To eliminate a double deduction, the accrued liabilities at the end of the preceding taxable year would be restored to income ratably over the period of years (not to exceed ten) the taxpayer had consistently reported income under the prior (accrual) method. *See* Section 481(b)(2) and Revenue Procedure 80-51, 1980-2 C.B. 818.

Grandfather provisions

Taxpayers who are properly accruing liabilities for worker's compensation under present law should be permitted to continue to accrue liabilities for worker's compensation. This is similar to the rules applied to accrual of vacation pay when restrictions upon accrual of vacation pay were enacted. *See* Section 463; *see also* Technical Amendments Act of 1958, § 97.

Estimated tax payments

If changes are made it should be made clear that taxpayers who have relied upon present law in making estimated tax payments are not subject to penalties or interest if their estimated tax payments are less than they should have been as a result of this change in the law.

The "economic performance" concept is not defined and should not be enacted

Our comments have been concentrated upon accrual of worker's compensation liabilities because deduction of those liabilities is one of a few items specifically identified by the Administration. The Administration's proposal is, however, to change the "all events" test to an "economic performance" test for *all* liabilities. That should not be done. The "all events" test is well established and based upon case law and long-standing Treasury Regulations. *E.g., United States* v. *Anderson,* 269 U.S. 422 (1926); Treas. Regs. §1.461-1(a)(2). It produces proper economic and accounting results in most instances. *See* Testimony of Emil M. Sunley, Richard A. Helfand and Albert B. Ellentuck before the Subcommittee on Oversight of the Committee on Ways and Means on "The Timing and Measurement of Taxpayer Deductions for Obligations to be Paid in the Future" (February 24, 1984). The "all events" test is well understood by taxpayers, the courts and the Service. It should not be generally replaced by an undefined new standard.

The Administration proposes definitions for "economic performance" in only a few instances. As pointed out, these proposed definitions are controversial and we believe result in improper matching of expenses with income in computing taxable income. Of equally great concern are all of the nonspecified liabilities for which no definition of "economic performance" is proposed. Examples include purchases of inventory, salaries, and state and other taxes. The Administration's proposals do not state what definition of the new "economic performance" test is to apply to these liabilities. Is it the same standard as applies under the "all events" test or the cash method as proposed for some liabilities?

We submit that no attempt has been made to state a new rule for accrual of most normal business expenses under the so-called "economic performance" test. We further submit that no new rule is required for such expenses and urge that this Committee reject the proposal to make a wholesale substitution of an undefined "economic performance" test for the long established and well understood "all events" test.

CONCLUSION

We appreciate the opportunity to present our views. The subject of tax accrual accounting before this Committee is complex and important. It deserves full and complete consideration before any changes are made requiring that different accounting methods be used by taxpayers. Insofar as worker's compensation is concerned, it is clearly not a tax shelter nor a tax motivated abuse and the proper answer requires careful balancing of the interests of the government to provide a fair tax system with encouragement for compensation of injured workers and promotion of efficient self-insured programs.

We will be happy to answer any questions now or by supplemental written comments and to work with your staff.

Thank you.

STATEMENT OF HON. LAWRENCE COUGHLIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF PENNSYLVANIA

Mr. Chairman, real estate syndications—specifically those private partnerships whose sole purpose is to channel large tax write-offs to wealthy investors—may be costing the federal treasury hundreds of millions if not billions of dollars in lost revenue without serving any worthwhile economic or social purpose.

Generous rules enacted in 1981 allowing for accelerated depreciation of real property combined with the tax deductibility of investment expenses and interest payments have spawned a host of public and private real estate syndications in the last several years. A December, 1983 *Forbes* magazine article, which I am submitting for the record, estimates that $2.5 billion was invested in real estate tax shelters in 1982 with the figure ballooning to $8 billion in 1983. Of this total, it is estimated that $4 billion went into the more lucrative private syndication tax shelters last year.

If that figure is correct, a two-for-one write-off for investors in the highest tax bracket—a fairly modest ratio by private syndication standards—would result in a substantial revenue loss to the treasury even taking into account alternative but less favorable tax shelters for these investment funds.

Basically, the "deep shelter" private syndicators operate by purchasing a hotel, shopping center or other property and then reselling it at an inflated price with heavy mortgages to individual investor-partners while collecting hefty upfront fees and commissions for themselves. The higher the price and bigger the mortgages, the better the tax write-offs for investors. Hence, the incentive to jack up the price, borrow as much as possible, and charge outlandish fees for putting the deal together.

For their initial investment, the partners receive large tax deductions for interest payments, expenses and depreciation, sometimes amounting to three or more times their original outlay. Typically, the real estate syndication investor is an individual in the top 50 percent tax bracket seeking primarily the avoidance of taxes on his income.

The real estate syndication structured around the Boca Raton Hotel and Club provides a good example of how the scheme works. After buying the property for $100 million, VMS Realty turned around and sold it to investor-partners for just over $140 million while guaranteeing millions in fees for itself in the process. The investors put up a total of $50 million with the remaining $90 million in deferred payment mortgages. The investor-partner receives an immediate two-for-one tax write-off for his investment for interest, expenses, and depreciation of the property.

The interest paid by investors accrues (giving them an immediate tax deduction) but is not actually paid to (or counted as income by) the seller/lender for many years. By that time, the syndication plans to sell the property, realize significant appreciation, and pay off the loan and accrued interest with a capital gain. What investors may not understand is that since the property's value is probably overstated to begin with in order to maximize tax write-offs, they may be stung in the final analysis by the poor economics of it all.

It should be stressed that not all real estate partnerships are designed for tax purposes alone. Many generate productive economic activity and these are not the problem.

The attached memorandum prepared by James J. Craig, Chief Accountant for the Pennsylvania Securities Commission, gives examples of five noneconomic real estate tax shelter deals. The following features stand out: (1) excessive tax write-offs for investors compared with the amount of their investment, (2) inflated price of the property sold to investors, (3) large initial fees and commissions paid to the partnership's promoters, and (4) little or no cash distributions projected for many years.

All of these factors point to the fact that the projects are structured for tax purposes rather than for sound economic reasons. The implications of allowing this type of abusive tax shelter to continue are clear: substantial revenue loss to the treasury, a bidding up of real estate prices generally thereby driving out economically motivated investors, and a further erosion of respect for the tax system as a whole.

When real estate deals can be structured so that wealthy investors realize tax write-offs that are two, three, or even four or more times their initial investment, without any corresponding economic or social benefit, something is wrong with our tax laws. The U.S. Tax Code includes numerous provisions intended to stimulate investment, productive economic activity and job creation, and we must be careful not to shut off these legitimate investments while plugging loopholes which allow for abusive tax shelters. However, some code revisions are clearly in order.

The existing loopholes on which real estate syndications are based and allowed to thrive are of basically three types. One loophole permits partnerships, using the accrual method of accounting, to take—and pass on to individual partners—a tax deduction for interest that is accrued but not paid to seller/lenders using the cash method of accounting. In this instance, a mismatch occurs in which deductions are taken annually by investors that are not included as income by the seller/lender for many years when the value will be less.

A second loophole occurs when property sales are structured so that the interest component of deferred payment transactions is understated or not stated at all. In such a case, the value of the property may be overstated to allow the purchaser to claim higher amounts for the investment tax credit as well as larger deductions for depreciation. On the other hand, some deferred payment transactions, for which interest is not stated and must therefore be imputed, are set up so as to accelerate several years' interest charges into the year of the sale. Both situations cause distortions of economic reality and permit tax avoidance.

A third type of loophole involves the fact that partners and partnerships are generally not now treated as "related parties" for tax purposes. Partnerships, the basis of many real estate syndication and resyndication schemes, are therefore excluded from the prohibition against an accrual basis taxpayer claiming a deduction for accrued interest and expenses owed to a "related" cash-basis taxpayer unless it is actually paid within the taxable year or soon after. Again, by using different accounting rules, the partners may be able to escape substantial tax liability by deducting interest accrued but not actually paid to another partner or related partnership.

I am pleased that your committee has noted this last problem and included a section (Section 492) in H.R. 4170 last year to extend the "related party" rules to partners and partnerships. I am also pleased that the Administration has made a number of loophole-closing revenue proposals grouped under "accounting reforms" and "tax shelter provisions" of the FY 1985 budget proposals. These would go far toward making real estate syndications less attractive investments.

The Pennsylvania Securities Commission, after studying the problems of real estate syndications, has also pinpointed a number of specific areas where federal law could be strengthened to correct abuses. I submit for the record a copy of a letter from Pennsylvania Securities Commission Chairman Robert Lam on behalf of the North American Securities Administrators Association Real Estate Investments Committee outlining several issues and proposing legislative solutions. I endorse the NASA's recommendations and urge the committee to approve these measures.

My concern, frankly, is that the Administration and NASA reforms may not go far enough to strip potential tax benefits from those real estate syndications established solely as tax dodges. Legislation should seek to identify those syndications which are clearly tax-motivated and to ensure that tax benefits are not longer available to investors attracted to them.

At least two criteria can be used to spot flagrantly abusive real estate syndications: (1) guaranteed tax write-offs for investors of two-to-one or more, and (2) promoters' projections of no significant cash distribution for ten years or more. Any real estate syndication exhibiting both these criteria is more than likely structured for tax avoidance and not for any economic purpose. These are red flags for this kind of deal.

For those syndications falling into the abusive category on the basis of these criteria, I would urge your committee to disallow completely a tax deduction for accrued but unpaid interest, and to revise the ACRS rules to stretch out the depreciable life of real property from 15 to 20 years. These changes would ensure that large deductions for accrued but unpaid interest would no longer be available to syndicate investors and that the deduction for depreciation would be less generous than at present.

With these changes, I am confident that tax-motivated real estate syndications would virtually disappear. Investment funds would then flow to more legitimate economically-oriented projects, and federal revenues would increase.

Mr. Chairman, the rapid increase in real estate syndications in the past several years makes it imperative that the tax laws be reformed. Ending these unconscionable shelters should be a top priority in our next tax bill. I urge quick action to close the loopholes which are allowing rich investors to drain the treasury with tax-motivated, noneconomic real estate deals.

[Agenda item No. 83-PD-185, Jan. 25, 1984]

To: The Commission.
From: James J. Craig, Chief Accountant.
Subject: Income Tax and Economic Aspects of Real Estate Tax Shelters Filed with the Commission.

Pursuant to your request, I am submitting this memorandum to complement the December 19, 1983, Forbes article "The Fellow Who Sold the Brooklyn Bridge . . ." (Exhibit I). I am also enclosing as Exhibit II a copy of portions of the "Readers Say" section of the January 30 issue of Forbes which included letters from VMS Realty and Pru-Bache about the article. Finally, I am enclosing as Exhibit III a July 15, 1983, Wall Street Journal article "Real Estate Tax Shelters Booming, but Critics Move to Trim Benefits."

It is the staff's opinion that the tax aspects of real estate partnerships result in misallocation of the nation's resources resulting in an overbuilding of apartment houses, hotels, shopping centers, office buildings and other real estate. Decisions are made solely for tax reasons rather than for economic ones. This has been especially true the last few years since the IRS effectively either eliminated or drastically reduced tax benefits for movie deals, cattle and other forms of tax shelters, by use of at-risk rules.The increase in real estate tax shelters increased not only because the risk rules are not applicable to real estate, but also because of ACRS depreciation. The increase in demand for real estate generated by the changes in the tax laws may have, in the staff's opinion, resulted in properties becoming overpriced thereby driving out those investors who are motivated primarily by economic rather than tax considerations.[1]

Exhibit III, the Wall Street Journal article, includes a bar chart showing the great increase in real estate partnerships in recent years. Although the results reflect, in part, the overbuilding occurring in real estate as mentioned above, it also reflects (in our opinion) a great deal of activity generated solely for tax purposes which are utterly devoid of any real economic motivation. They result in contributing to the federal deficit and serve only to enrich sponsors, lawyers, accountants and other professionals. The following are examples of some filings which illustrate the economic and tax shelter programs:

EXAMPLE I—PARAMETRIC GARAGE ASSOCIATES

This was an offering $6,950,000 of which $1,940,000 was used for syndication fees, commissions, principal and interest on an existing loan, etc. The balance of $5,010,000 is paid not to the company, but to the former limited partner. None of the proceeds of the offering goes for bricks and mortar; the project had already been built in 1983 at a cost of approximately $10,000,000 and was financed principally from an issue of tax exempt bonds in the amount of $15,250,000. The difference between the $10,000,000 and the $15,250,000 includes interest expense, consulting fees, legal, accounting, salaries of the managing general partners, $900,000 for the cost of issuing the tax exempt bonds, $2.4 million set up as a bond reserve fund, etc. Thus, the proceeds of the $6,950,000 offering are primarily to permit the new limited partners to purchase an interest in the already existing enterprise.[1]

Based on forecasts and projections included as part of the offering circular, the new limited partners, the investors, will receive *no* cash distribution through the year 1994. The investor, if he or she is in the 45 or 50% tax bracket, will enjoy substantial tax benefits. For an example, an investor in the 50% tax bracket investing $50,000 for one unit over a period of several years would receive no cash distribution, but would have tax savings of $89,000. The interest on such tax savings is projected at $19,335 so that the investor would accumulate, purely from tax savings—not from any cash distributions, $108,242.[2]

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[1] The amount of fees paid to promoters, attorneys, accountants and other professionals are considerable. For instance, in the 500 Grant Street offering, $53,450,000 is paid to Integrated Resources. $4,500,000 was paid from the proceeds of the offering and the balance was deferred, but the amount deferred pays simple interest at 17% per annum. With respect to Boca Raton, as indicated in the Forbes article, it is suggested that the investor is paying $140,000,000 for a property that had just been sold for $100,000,000. Even taking into consideration the rebuttal in the January 30th Forbes, it would appear that approximately $20,000,000 of the total cost was accounted for by fees and expenses. With respect to Parametric, as mentioned above, of the $6,950,000 paid by the limited partners, $5,010,000 goes to a prior limited partner. Of the balance of $1,940,000, $695,000 is for commissions and expenses, $175,000 for legal and accounting, etc. Thus, it would appear that much of the activity involved in putting these deals together accounts for a substantial part of the upward pricing of the properties.

In addition to the upfront fees, the sponsors generally receive substantial amounts from ongoing operations including management fees, consulting fees and monitoring fees. As the Forbes article points out, in the case of Boca Raton, VMS will receive about $1.5 in consulting and partnership monitoring fees over several years and expects to get supervisory management fees over the next 15 years, totalling over $20 million. All of the other examples cited include various types of ongoing management fees.

[2] Several of the examples cited refer to investors not having to put up any of their own funds. The following is an example (taken from 500 Grant Street) of how this process works.

In 1983, the investor makes an initial investment of $4,775. His share of the partnership losses for 1983 amounts to $15,380. As he is in the 50% tax bracket, he saves taxes of $7,690; so that he

Continued

It should also be noted that the program is projected to have taxable losses every year through 1996 and taxable losses before depreciation and amortization through the year 1993. It should be noted that these losses will occur even though the program will incur relatively low interest expense because of the tax exempt nature of the program's outstanding bonds.

EXAMPLE II.—500 GRANT STREET, PITTSBURGH, PA.

In this program each limited partner will invest $213,737 ($155,275 plus interest of $58,462) paid over an eight-year period. Based on the projections, no cash distributions are scheduled to be paid to the investors until the year 2004, and it is not until the year 2010 that the investor will recoup his or her investment. This project does not appear to be a sound investment from a purely economic viewpoint, but for a taxpayer/investor (provided he is in a high tax bracket) the deal may be fabulous. By the year 1998 the investor will have received after tax benefits of $392,847 representing cash of $179,080 in excess of the investor's cash outlay of $213,737. The projection also figures that if the annual tax savings are reinvested at 8% (this low percentage rate of interest, no doubt represents tax exempt interest) his cumulative cash "profit" after taxes through the year 1998 is $280,128.

As a practical matter, provided the investor is in the 50% tax bracket, the $280,128 is reached without the investor putting up any money. (See Note 1.) Each year the investor's tax savings exceed the amount of cash he has to put up. Accordingly, except for the short period (possibly a miniscule period) between the time he lays out the money and the time he files his tax return or his estimated tax return, he will never be out of pocket any funds. As we see it, the only risks to the investor are the possibilities that (1) the IRS may successfully challenge this scheme or (2) the investor suffers personal financial reverses (from factors exogenous to his investment in the partnership) that result in his being in a lower income tax bracket.

One wonders what the economic motivation for the program is. The partnership purchased a partially constructed office building in Pittsburgh from United States Steel Corporation, which has agreed to complete construction. The building is to be leased to Mellon Bank. Presumably the building would be completed and leased regardless of whether or not the limited partnership purchased the partially built structure. The limited partners get no economic benefit until very far into the future; as indicated above the tax benefits, however, are tremendous.[3]

Although the limited partners get very little economic benefits from the projection, the same cannot be said about the promotors any syndicators. For example, the sponsor of the program, Integrated Resources, is to receive $53,450,000 in origination fees, of which $4.5 million was paid from the proceeds of the offering and the balance from revenues over time. Other amounts paid from the proceeds of the offering include $2,717,000 as finder fees to Goldman Sachs, $400,000 in legal fees, and $500,000 in syndication fees.[1]

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really has no out-of-pocket costs. Instead, he has a cash inflow of $2,915, the difference between his tax savings of $7,690 and his "investment" of $4,775.

The process continues. In 1984, he invests $27,613; his share of the partnership loss in 1984 is $70,638 which will reduce the taxes he would otherwise have to pay by $35,319 (i.e., 50% of $70,638). Thus, his cash inflow is $7,708—his tax savings of $35,319 less his cash invested of $27,613. (Although it might appear superficially that he invests $27,613 in 1984 and does not get his tax reduction until April 15, 1985, as a practical matter, it won't happen this way because the taxpayer will reduce his estimated tax payments during 1984. Therefore, he will get his cash inflow immediately and, in a sense, will not be putting up any of his own money.

The process continues on with the investor never at any time having to put up any of his own money. The investor/taxpayer, of course, will also receive income from reinvesting his net cash inflow.

Variations of the arrangements described in this footnote are not uncommon. Some form of such arrangements are found in Example I (Parametric), Exampe III (Homeshare), and Example V (Boca Raton). In the latter offering the investor in some years has to make an actual cash investment in excess of tax savings, but the maximum cumulative net investment is only 15.8% of the original contribution and interest payments. This arrangement is not applicable to Example IV (City of Brooksville—Tangerine) because in that situation the partners put up no money.

This footnote has been provided for illustrative purposes only. The tax effect may vary because of minimum taxes and investment income limitations.

[3] Many of the real estate offerings involve refinancing arrangements of one kind or another and do not actually involve any new construction. Of the examples cited, only the one referring to the City of Brooksville involves much in the way of new investment, and in that situation the actual capital is being provided by tax exempt bonds. The partnership itself does not make any investment.

EXAMPLE III.—CITY OF BROOKSVILLE, FLORIDA

(Tangerine Retirement Center Project)

This is an offering in which it is intended to issue $4,225,000 in tax exempt bonds to be used to acquire land and an existing hotel and converting it to a 90 unit adult living facility.

The facility is to be owned by a limited partnership. Based on projections provided, the partners will not put up any of their own money. All the capital will be provided by the tax exempt bonds. It is projected that the partnership will incur substantial losses in the early years of the project. The partners will accordingly enjoy substantial tax benefit from the losses even though they are not investing any of their own money. (The principal partner—who is a wealthy individual and owns 90% of the partnership—guarantees the bonds, but the guarantee is only for five years; accordingly, his risk is minimal. The risk is also minimal because a substantial amount of the proceeds of the bond issue is set up as a reserve to cover principal payments in the early years.[2]

Based on projections provided, the facility will have tax losses in the first four years of $569,526. Most of these losses will be passed through to the principal investor, thereby reducing his income taxes substantially. The projected figures are actually based on using straight line depreciation; if accelerated depreciation is used, his tax benefits will be much greater. Thus, this investor with very little money at risk will enjoy very substantial tax benefits. Virtually all of the financial risks are being borne by the holders of the tax exampt bonds.

EXAMPLE IV.—THE HOMESHARE PROGRAM: SERIES D

In this program the investors make an investment of $55,000 per unit. A maximum total of 40 units are being offered. The program plans to purchase houses using a wrap around mortgage, renting the houses, and subsequently selling them at an appreciated price some years in the future.

Based on projections provided, the amount of rents received by the program will not nearly cover expenses and debt service. The program solves this difficulty by arranging a mortgage in such a way that most of the interest is accrued rather than paid. Implicit in this program is the notion that the value of the homes will appreciate enough to cover not only the principal portion of the unpaid mortgage but will also be enough to cover the interest accrued but not paid.[4]

Under this plan the partnership will incur very heavy losses for tax purposes. Some of the heavy expenses include the interest which they will be accruing but which they will not be paying. The benefit to the investor will arise from the heavy losses being passed through to them which will help to reduce their income taxes. As mentioned above the losses include the interest accrued but not paid. As you know, individual taxpayers who are almost always on a cash basis cannot deduct interest expense unless the amount is paid. Accordingly, it is very inconsistent to permit a partnership to pass through these interest deductions to the individual partners when the interest has not been paid.

In earlier offerings of the Homeshare Program, they attempted to take interest deductions based on the Rule of 78. The Rule of 78, as used by Homeshare, contemplated computing the total interest payments due under a mortgage and then recording the interest expense on the sum of the digits basis. This resulted in the program's claiming a tremendous amount of interest expense in the early years of the mortgage, even though these amounts were not paid. The IRS, in a revenue ruling, (Rev. Rul. 83-84) outlawed the use of the Rule of 78 in real estate deals. However, they apparently have not as yet taken an official stand with respect to a partnership taking an interest expense on an accrual basis and passing such expense through to the individual cash basis taxpayer investors. The IRS is aware of the problem, of course. According to the Forbes article, it is trying to get Congress to disallow accrued but unpaid interest as a tax deduction.

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[4] The problem with respect to the accrual of interest arises because the investors/taxpayers, who are usually on a cash basis, can generally deduct interest expenses only in the years that they are paid. However, the limited partnerships elect to use the accrual method. Under this method they can deduct as an expense, interest which will not be paid until some years in the future. Such interest expense (together with other items of income and expense of the partnership) are passed through to the individual partners thereby permitting the individual taxpayer/investor to take as a tax deduction amounts of interest accrued which he would not have been able to take as an individual, if it were not for the fact that the amounts in question are being passed through by the partnership. The partnership acts as a conduit. This is a rather common element in real estate limited partnership programs. As an example, with respect to Boca Raton, the partnership will pay $13,592,100 in interest expense in 1984, but will accrue and pass through to the partners $19,118,500 as interest expense. With Parametric the partnership will record as interest expense over $4.9 million, but it will not pay this amount until the property is sold. Nevertheless, the individual partners will be able to take their portion of the $4.9 million as an expense for tax purposes.

EXAMPLE V.—BOCA RATON HOTEL AND CLUB

The problems connected with Boca Raton Hotel have been pretty well covered in the Forbes article. We would like to add one point. In the January 30th issue of Forbes (Exhibit II), the Executive Vice President of Prudential-Bache Securities pointed out that, "Investors in Boca Raton can expect an 18% after tax return on their money, *even if foreclosure happens.*" (Emphasis added.) In our opinion this statement epitomizes one of the things that is wrong with tax laws as they apply to real estate tax shelters. Because of our tax laws, poor judgment and unsound investments can be richly rewarded.[1] [2] [3] [4]

SUMMARY

The principal problems with respect to economic and tax factors in real estate limited partnerships can be summarized as follows:

(a) Excessive compensation to promoters and sponsors tends to sharply increase the price of real estate without any corresponding economic value.

(b) The use of the accrual method at the partnership level—especially with respect to interest—creates a distortion of income. It also permits individual taxpayer/investors to enjoy certain tax advantages by going through a partnership, which they cannot do as individuals.

(c) Many partnerships are being financed, either entirely or in major part, by tax savings. Tax exempt bonds are being used to reduce the interest expense of partnerships (hence, the individual investor partners) in situations where the partnership is nothing more than a refinancing vehicle and does not represent any real capital investments. (We are not, of course, referring to the tax advantages enjoyed by the holders of the tax exempt bonds.)

(d) The use of incentive management fees to further enhance the profits of promoters and sponsors.

EXHIBIT II

Readers Say

Unsheltered investors

Sir: Your cover story, "The fellow who sold the Brooklyn Bridge . . ." *(Dec. 19, 1983)*, was a superb attack on the excesses of tax shelters. I advise my readers to avoid any transaction involving intermediaries, and to approach interest accruals with eyes open. The IRS will knock out both devices when it figures them out.

—Arnold G. Rudoff, JD, CPA
Editor,
Limited Partners Letter
Menlo Park, Calif.

Sir: Your article implied that investors might have overpaid for the Boca Raton Hotel investment because they bought for $140 million what was just previously sold for $100 million. The $40 million spread includes approximately $26 million of capital improvements, working capital and interest reserve. The balance went for third-party out-of-pocket costs, including a well-deserved fee for Prudential-Bache, which underwrote and distributed the partnership units.

Your analysis of how an investor will come out under various scenarios did not take into consideration the time value of money, nor did it state a final result.

—Joel A. Stone
President,
VMS Realty, Inc.
Chicago, Ill.

Sir: Syndications like our Boca Raton Hotel and Club private placement are excellent investments. Our fees and other compensation are not only standard for such transactions, they are also well earned by the work we do in structuring, analyzing, planning, distributing and monitoring the investment for more than ten years.

Investors in Boca Raton can expect an 18% aftertax return on their money even if foreclosure happens.

—Robert J. Sherman
Executive Vice President,
Prudential-Bache Securities
New York, N.Y.

The offering memorandum [p. 14] indicates that $7.7 million of the total interest reserve will be paid out of the reserve, presumably to VMS, over a seven-year period. That means that around half of the increase of $40 million in debt will be accounted for by fees and commissions, not an inconsiderable amount.

Pick a set of assumptions and discount rates and you can come up with all sorts of returns. But what do they really mean? If the Boca deal turns out to be as terrific an investment as you anticipate, Forbes will be glad to write about it then.—Ed.

Exhibit III

WALL STREET JOURNAL
July 15, 1983

Real-Estate Tax Shelters Booming But Critics Move to Trim Benefits

By RANDALL SMITH
Staff Reporter of THE WALL STREET JOURNAL

The 450 investors buying Continental Corp.'s New York City office tower are getting much more than just a chunk of Manhattan real estate. In the first seven years that they own the tower, they will chip in $306,000 each in cash. But in the same period, they each stand to gain tax deductions projected at $672,000. Assuming the investors are in high tax brackets, the tax savings alone will exceed the cash outlay.

While the investors will technically own the building, the insurance company the building is named for has guaranteed to lease it for 30 years and pay all operating costs, making the risk minimal. "It isn't hard to see how these deals always sell out so quickly," says Disque Deane, chairman of Corporate Property Investors, a large real-estate investment trust.

Even while the office rental market is still in a slump and the housing recovery has just begun, real-estate tax shelters like this one are booming. But the more the shelters grow, the more vulnerable they become. The boom results largely from a 1981 change in the tax laws governing depreciation that makes the deals more attractive than before. Now a move to trim back the new tax advantage is gaining momentum in Washington. Its backers say the rapid growth of the shelters proves that the tax benefit is too generous.

Surge in Sales

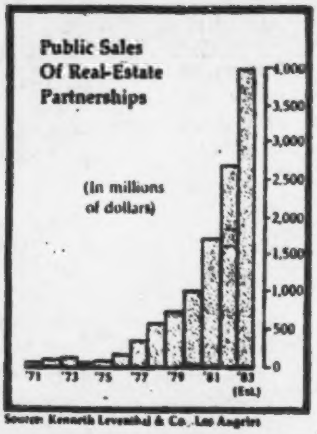
Public sales of real-estate tax-shelter partnerships soared to $2.7 billion last year from $1 billion in 1980, and they should rise to about $4 billion this year, says Kenneth Leventhal & Co., a Los Angeles accounting concern that tracks such sales.

Besides such public partnerships, registered with the Securities and Exchange Commission, private partnerships sold without SEC registration totaled between $8 billion and $20 billion last year, also a sharp advance from previous years, Leventhal adds. "It's like wildfire. I've never seen anything like it in my life," says Mr. Deane.

The 1981 tax-code change helping the boom shortens the "depreciable life" of income-producing property to 15 years from a previous range of 30 years to 50 years. Depreciation allows an owner to deduct over time a property's cost from taxable income. The new 15-year schedule gives the owner of a $100 million building an annual deduction of $6.7 million, instead of only $2 million to $3.3 million under the old rules.

The tax-code changes were meant to stimulate construction. But the change is expected to cost the Treasury about $4.3 billion in the fiscal year ending Sept. 30 and more than $10 billion in the year ending Sept. 30, 1986. With Congress grasping for ways to close huge budget deficits, the real-estate tax shelters are becoming a tempting target.

"There is a great deal of revenue loss being generated that's producing no positive economic activity," says a Senate Finance Committee staff member. Some property owners "are just sort of trading properties around" to enhance their deductions, he adds.



Public Sales Of Real-Estate Partnerships

(In millions of dollars)

Source: Kenneth Leventhal & Co., Los Angeles

The 15-year depreciation rule is "one of the largest targets" for those who want to take back some of the 1981 business tax incentives, says an aide to Democratic Rep. Dan Rostenkowski, chairman of the House Ways and Means Committee. Rolling back the depreciation to 20 years "is an option on a lot of lists," he adds.

On the Republican side, Senate Finance Committee Chairman Robert Dole is reportedly reluctant to make another change in the depreciation rules because they were changed in both 1981 and 1982. But aides talk of changing the rules to block "churning," sales of existing buildings, allowing new owners to gain the 15-year depreciation and a higher price basis for the deduction. The Finance Committee has encouraged an Internal Revenue Service crackdown on all sorts of abusive tax shelters, including some that involved inflated real-estate write-offs.

Some in Washington are especially concerned about lease-back deals. Financial

Boom in Real-Estate Tax Shelters Sparks Moves to Reduce Benefits

corporations with relatively low tax bills, such as Continental Corp. and First National City Bank of Houston, have sold new buildings to real-estate tax-shelter partnerships and leased them back. As the tax benefits are a primary benefit to investors, these deals are often called "depreciation strips."

—Local governments and other tax-exempt institutions find the deals alluring too. Reginald Todd, an aide to a Texas Democrat on the House Ways and Means Committee, J.J. Pickle, notes that Washington, D.C.; Atlanta; Battle Creek, Mich.; and San Jose, Calif., are thinking of selling their city halls in leaseback sales of convention centers; Philadelphia may sell a jail, and Bennington College in Vermont may sell its entire campus, Mr. Todd notes.

Rep. Pickle introduced a bill last month to curb such lease-back transactions by tax-exempt entities. He warns that the practice could lead to "staggering revenue losses," create billions of dollars worth of new tax shelters and foist "shaky financing schemes" on the public.

Sharing the Benefits

Meanwhile, the partnerships are making money for plenty of people, including the syndicators who sell them. These entrepreneurs buy properties and then resell them to groups of investors called syndicates or partnerships. The investors share in the income, appreciation and tax deductions that their properties generate. The syndicators collect sales commissions and fees. Of the $137.3 million in cash to be invested in the new Continental Tower, some $36 million, or 26%, will go for fees to the syndicators and others. These fees equaled 16% of the $221 million total purchase price.

Integrated Resources Inc., whose biggest activity is real estate partnerships, says its profit surged to $22.4 million last year, up 52% from 1981. Revenue of $176 million last year was more than double the level two years earlier. The company's stock, which closed on the New York Stock Exchange at $41 Friday, has more than tripled in value since mid-1982.

Until lately, six big companies, including Integrated Resources, have dominated the field. But lately, the big financial "supermarkets" have increased their stake in the business. American Express Co. last year bought one of the six big syndicators, Balcor Co., which has since doubled its property partnership sales. Merrill Lynch & Co., the nation's largest securities concern, started its own syndication unit in 1979, and has doubled its volume every year since then.

Please Turn to Page 39, Column 1

Continued From Page 25

In addition to the tax-law changes, syndicators have benefited from inflation, which has bolstered their track records. JMB Realty Corp., a large syndicator, says that since 1971 it has sold properties costing $52 million for $132 million.

The syndicates also benefit from declining returns of some other kinds of tax shelters and from the nature of real estate investment. Syndicates can purchase a building for a small down payment and take a large mortgage. As they base depreciation on the total purchase price and deduct the mortgage interest as well, they can obtain tax deductions far greater than the cash investments.

Because mortgages have the property as collateral, investors don't risk being forced to repay loans that turn sour. In most other types of tax shelters, they do.

Private partnerships generally involve more borrowing and more risk than public partnerships, but tend to provide bigger tax breaks. Unlike public partnerships, which must demand payment all at once, private partnerships can allow investors to pay in their cash over several years. This lets investors' tax deductions exceed cash payments for several years, which helps private partnerships to raise cash.

In the past year, private partnerships have rocked the industry with huge deals. Chicago's VMS Realty Inc. has announced the purchase of two hotels and an office building for a total of about $290 million. Integrated Resources plans to acquire the Mellon Bank headquarters in Pittsburgh and resell it to one of its partnerships for about $280 million.

For all the fear of tax law revisions, there is little sign that the pace is slackening. Says mortgage banker Arthur Sonnenblick, "There is a ton of money out there."

What's the quickest way for a sponsor to offer the maximum tax writeoff in a real estate shelter? By raising fees and commissions. Does that tell you something about realty syndications?

The fellow who sold the Brooklyn Bridge to tourists might have done better packaging real estate syndications

By Howard Rudnitsky
with John Heins

Las Vegas, home of the slot machine and the 24-hour casino. What an appropriate spot for showcasing tax shelter products—a dicier investment vehicle would be hard to find. So, here they were, at a convention in the Las Vegas Hilton: 260 different sponsors of shelters and 5,000 financial planners who peddle such goods to hot prospects.

And these fellows have deals for you. Tax straddles, oil deals, R&D shelters, cattle and gemstones.

What kind of tax shelter merchandise is moving best these days?

No question there. Real estate. For every dollar going into the once-popular oil and gas deals these days, probably two dollars go into all real estate syndication deals. Last year the public sank about $2.5 billion into real estate tax deals. Some experts think the figure will rise to over $4 billion this year. That would be enough real estate tax shelters sold this year to generate a probable $750 million in fees, commissions and Lord knows what else.

We are talking here only about so-called private deals, made essentially for tax reasons. There is another $4 billion—and another $800 million or so in commissions and fees—in so-called public deals. Unlike private offerings, which typically invest in a single property, the public ones invest in a pool of properties and are supposed to be investments that pay moderate returns and hold out hope for a capital gain somewhere down the road. The public offerings also are booming, with an expected growth rate of 80% over 1982. But "public" and "private" are misleading, both kinds of deals are offered to the public. The private deals call for deeper pockets.

It's easy to see why real estate is the hot product. So far as private deals are concerned, in one package the prospect gets to diddle Uncle Sam and to own a piece of prime real estate.

Who could resist it? Who would even want to haggle over the price? After all, you are paying for the deals with only 50-cent dollars, aren't you?

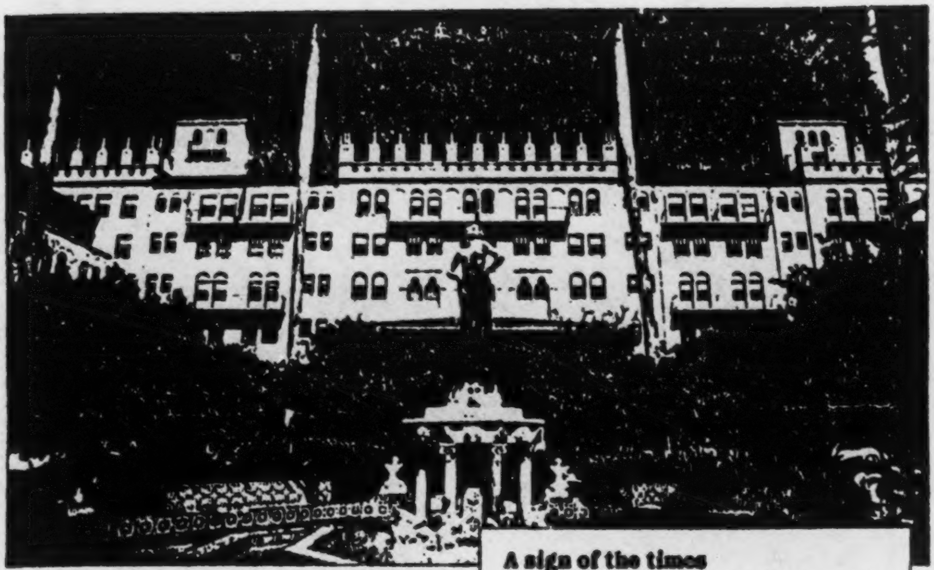
Well, yes and no. Yes, you are paying with 50-cent dollars (assuming you are in the 50% bracket), but you aren't necessarily getting your dollar's worth in the first place. For those 50-cent dollars you may get 40 cents' worth of real estate.

Why? First, the syndicators and brokers take a big bite (over 20%) out of the client's investment before it's put to work. That alone can make an otherwise good investment produce a mediocre return. Second, despite their self-described expertise, many syndicators turn out to be better at promoting than they are at investing. Third, a lot of the stuff they are peddling is so overpriced that there's little chance you will ever come out ahead.

Another thing the salesman often forgets to mention: If the real estate deal you are investing in goes broke, you may open your mail one day and find a fat bill for back taxes. It has happened before. It will happen again. You lose both your money and the writeoff—plus interest and penalties, if the IRS rules the offering to be uneconomic.

Let's get back to that $8 billion or so investors are sinking into real estate syndications this year. When fees, commissions and offering costs are whacked away, about $6 billion is left for actual property acquisitions. With double-digit inflation—and equivalent gains in rents and realty prices—you can come out whole that way. But otherwise you can't.

That $6 billion this year will provide enough equity to purchase over $15 billion worth of apartments, office buildings and shopping centers. Now, $15 billion is a lot of money, and, competing against the cash of pension funds, insurance companies and foreign buyers, it is helping



A sign of the times

Pictured above is the Boca Raton Hotel, part of the well-known resort property now being offered in a realty syndication. There's something in the deal for everyone *(see story)*, especially the syndicators, the middlemen and the sellers. The investors? They get a 2-for-1 writeoff and hope of a capital gain somewhere down the line. But right now, they will have bought into a property currently priced at $140 million that earlier this year sold for $100 million. It's a sign of the times.

to push up prices in many kinds of realty merchandise, stacking the deck even further against the investor. One group recently paid $58 million for a downtown office building in a large Western city. The asking price had been $50 million.

Dumb? Not from the syndicator's viewpoint. He was willing to pay more because he got better terms—he put up less equity. Remember, to his investors he is peddling tax advantages. The higher the loan, the greater the depreciation and interest costs—and the more tax writeoffs.

But this kind of deal could be poisonous for the investor. Why? Because heavy leverage involves risks, and if the market turns bad, the top-heavy financing could wipe out the equity. The creditors would get the property back, the syndicator would keep his fees and the investor would get the shaft. Somehow, the point that there are dangerous risks in a highly leveraged property—negative cash flow and large, deferred interest payments that will have to be paid off in time—gets obscured.

What are the realty syndication investors getting for their money? It depends. If they are in the public syndications, which offer income plus potential capital gains and less emphasis on tax shelter, they are often getting only a mediocre investment without much risk. Not dangerous, but why pay fat commissions to get locked into an illiquid, mediocre investment?

And what about the other kind, the private tax writeoff deals? Watch it, brother. Insiders usually keep the really good ones for themselves. Most of the rest are overpriced or overleveraged or sometimes both.

Let's look at a relatively "conservative" deal:

How would you like to buy a piece of the five-star Boca Raton Hotel and Club, one of the choicest resort properties in the U.S.? Sounds great? It's for sale by VMS Realty, Inc. at $200,000 a unit, using Prudential-Bache Securities Inc. as the middleman.

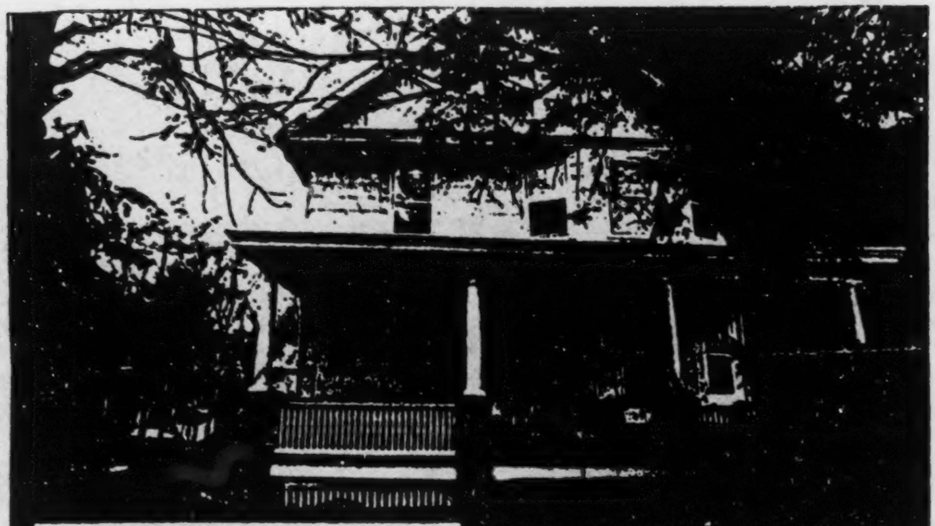
The photos look great *(see above)*. VMS recently paid $100 million for it to Arvida Corp. Investors from all over the country will have put up $50.6 million in cash and notes and will have $90 million worth of first and second mortgages on the property to go with it. Total, just over $140 million.

Now think that one through. With a stroke of the pen, VMS and its friends ask investors to cover another $40 million in price (including transaction costs) on top of VMS' purchase price, which may not have been a bargain in the first place. Assume the true market value is what VMS paid for it. In that case the public investors get some $10 million in equity for their $50.6 million. There's quite a deal!

Where's the rest of their equity? Before a dime goes into the property itself, 15% of their investment is taken off in third-party front-end fees. This is fairly typical, as these costs go. More shameless syndicators eat up even more. The excuse: The bigger the bite, the bigger the tax writeoff.

A big chunk of the 15% goes to Pru-Bache and others for selling the units to investors. They will earn $3.5 million in sales commissions, plus a $1 million "Non-Accountable Expense Allowance." In addition, through an affiliate the broker will be entitled to a 5% limited partnership interest at 30% of the rate paid by other limited partners. There goes another piece.

The limited partners were also hit with a (front-loaded)



You could do it yourself

In 1980 a doctor in Bergen County, N.J. bought this house for $85,000—$20,000 in cash—as a tax-sheltered investment. Only 28 months later he sold the house for $99,650 (after commissions and costs). Between the increase in value of the house and the slight paydown on the mortgage, the doctor wound up with just under $35,000. Not bad. It took some work—the doctor rented out the house in the interim to offset mortgage and maintenance costs. His timing was good—prices in the area were rising. And he was lucky—his buyer found a mortgage. There is no guarantee he could do that well again. But at least he knew for whom he was working.

$3.2 million loan fee. If that weren't enough, the bank providing the mortgage loans would also be entitled to 5% of the property's fair market value in ten years, above $115 million.

The biggest beneficiary of all: sponsor VMS Realty. In addition to an $8 million markup added on to the property for acquiring it, VMS will receive about $1.5 million in consulting and partnership monitoring fees over several years. VMS also expects to get supervisory management fees over the next 15 years, totaling over $20 million, based on its own estimates. Later, VMS could earn a 10% gross sales fee, when any of the units are sold or converted to condominiums. VMS also acquired 5.6 acres of undeveloped beachfront land adjoining the Boca Raton property, for a reasonable $1 million, payable over 15 years at 10% interest cost. Oh, and one thing more. As holder of the loan that wraps around the first and second mortgages, VMS each year will receive $1.1 million more in interest than the underlying mortgages require. That's because the interest rate VMS is charging the limited partners is higher. The boys do take good care of themselves.

Boca's previous owner does all right, too. Arvida, besides the capital gain on sale, negotiated an attractive 20-year renewable contract to continue managing the luxury resort. It will net close to $3 million a year in fees. Maybe more, if profits are better than expected.

Oh, yes, the investors. What about them? About a 2-for-1 writeoff and a hope. But not an easily realizable hope of capital gains because of the high price, the onerous debt costs and the fees and commissions. Capital gain? Remember, an informed seller let it go for $100 million, and the investors are in effect buying it soon after, at $140 million.

So what? you say. At the 50% tax bracket, 2-for-1 means a free ride, doesn't it? Even if I lose all my money, I still break even after taxes, don't I? Not quite. Look at the Boca Raton deal again. To get in you agree to put in $200,000 in installments over six years. On each year's installment the investor gets to write off against regular income upward of 200% of what he puts in that year. Hold it, though. We forgot to mention interest. That raises the total cost of the unit to $265,600. Well, the interest is deductible, isn't it? Yep. So what's wrong with the deal? What's wrong with putting in $265,600 and getting $447,400 in tax writeoffs over the pay-in period? If you are in a 50% bracket, the federal government is footing most of the bill, and you come out the other end with a prime piece of real estate. Besides, 2-for-1 on tax deals is considered modest and unlikely to rile the IRS.

What's wrong with the deal? Only this: The investor really hasn't the foggiest notion what he's going to come out with when the loans come due ten years hence. Remember, even after tax offsets, the most he was ever in the deal for was about $40,000 plus foregone interest. And what does he have? At the end of ten years he has a 1/253rd interest in a nice piece of property. All it cost him was some cash and foregone interest. But then comes the hitch. The property, after ten years, is mortgaged for $138 million because the interest on the underlying mortgages has been capitalized. Didn't the investors' money go into paying down interest and amortizing the mortgages? Oh, no. Where did the investors' money go? A lot of it went into the sponsor's pockets or into the pockets of other people involved in doing the deal.

So it depends on what the property is worth a decade hence. If it has appreciated 50%, the investor gets nothing because accrued interest and other costs will eat up the gains. If it has appreciated 100%—about 7% a year, pretty good—the investor would come out barely better than even on the total investment and would have gained by the amount of tax saving.

But are you willing to bet that real estate will double in value over the next decade?

End of caveat? Not quite. Suppose inflation stays down and there isn't much appreciation. Say the property is worth only $130 million after ten years, and the bank forecloses. What happens then? Internal Revenue could come in and disallow, retroactively, some of your tax writeoffs. Then you owe Uncle Sam a nice piece of change. It's complicated, but it works this way: If you lose on the property, you may lose on taxes, too. That's the way it is.

Jerry Reinsdorf, a cofounder of Balcor
There's no doubt the syndicators can do well. For Balcor, it amounted to a $80 million reward from a standing start just 10 years before.

Far more "aggressive" tax deals are being put together these days, and people are eating them up. Many of these are so-called "K mart" lease deals, which have little to do with K mart except that most of the first ones were written around a deal involving a K mart store. These offer 3-for-1 rather than 2-for-1 writeoffs. How do you get a 3-for-1 writeoff, anyway?

Most of these deals are structured more for tax purposes than to make economic sense. The investors start out buying the buildings for maybe 5% equity, 95% debt. The leverage is sky-high, and so are the tax writeoffs. These deals, however, in the words of *Real Estate Tax Shelter Review* Editor Charles Wetterer, "can turn around and bite you in the ass." How they bite is, again, very complicated, but the bottom line is that the tax advantages get used up in the early years and the investor gets credited with taxable income even though he may not see a dime in cash. Tax savings in the early years. A tough tax bite in the later years.

But how can you lose in, say, a shopping center? Aren't you almost certain to see it appreciate faster than inflation? Maybe, maybe not. Listen to this analysis of a Connecticut shopping center offered as a K mart deal [but not actually involving K mart]. The analysis was done by Scott Miller, California-based financial consultant who analyzes tax shelters for insurance companies, stockbrokers and individuals:

"It is an offering that requires trusting and unsophisticated investors. The investors are expected to believe [the general partner] will not eventually abandon what could be an unprofitable lease. There is no guarantee that the lease terms will be performed by [the general partner]." If the GP's overly generous assumptions of rent increases don't pan out, he reasons, "There is an incentive for [the GP] to eventually abandon the project." To believe otherwise, in Miller's analysis, is to believe that the syndicator is going to absorb losses for many years.

What else? "The property is worth no more than the $10.4 million cost to the sponsor. On top of that, an uneconomical 35-year master lease devalues the property." Yet the investors will have to pay in $7.3 million and assume debt of $11.1 million.

"I am surprised," Miller says, "that a reputable accounting firm would lend its name to an offering of this low caliber." He shouldn't be. The sponsor got favorable legal and accounting opinions that the project was economically viable.

Another 3-for-1 tactic: overloaded resyndications, using federally assisted Section 221[d][3] and 236 programs, and Section 8 HUD housing projects. Because much of the depreciation benefit from the original tax shelters of this kind are running out, new investors are buying in to start taking tax writeoffs all over again.

Do you know the easiest way for a sponsor to get you a 3-for-1 or similarly high writeoff? Simply by jacking up his fees. Explains Eugene Glick, president of Gene B. Glick Co., Inc., an Indianapolis-based syndicator of subsidized housing partnerships: "They improve the return by running up the fees that they charge the investor, who then uses it as a tax deduction. But they could also run the risk of a tax audit and a disallowance by the IRS."

In short, 3-for-1 probably means ringing a bell at the Internal Revenue Service. One particularly egregious deal, a vacancy-plagued Section 8 apartment building in Pontiac, Mich., raised $2.2 million in highly leveraged capital from investors. The sponsors' and consultants' fees could amount to two-thirds of the investors' money, and include a $549,000 consulting fee for Management Assistance Group, Inc., which in turn purchased the consulting services of A. Bruce Rozet.

Readers of FORBES may recognize the name. In the late 1960s Rozet ran Commonwealth United Corp., a conglomerate that slithered into liquidation shortly after Rozet departed. Rozet next turned to selling government-subsidized low-income-housing deep tax shelters in the mid-1970s. A number of these went into foreclosure (FORBES, *Oct. 1, 1976*). More recently Rozet appears to have become a middleman. He packages government-assisted projects for other syndicators, who then sell them to investors.

Listen to Mark Sayers, vice president of EMES Management, a New York-based real estate investment firm. Sayers knows what he's doing, with over ten years in the real estate business, including a stint at Lehman Brothers, before joining his family's business. Sayers laments that a close relative seriously considered going for a sexy writeoff deal. Says Sayers: "He [the relative] looked at a deal with a 3½-to-4-for-1 writeoff, over ten years. They have heavy accrued interest. There is no cash flow. They justify the heavy accrued interest by appraisals, which you can always find." Again: a deal structured for tax avoidance rather than for real estate common sense.

"This type of deal," says Sayers, "or some of the brokerage house deals, where they offer 3-for-1 or higher losses—that simply isn't possible with an economically oriented investment. It can't be done. If it could, I'd be doing it."

Yet such deep tax deals are being done by brokers and syndicators every day. Look at Integrated Resources, Inc. a tremendous success story in the wonderful world of tax shelters. It is, among other things, the largest single sponsor of real estate syndication programs in the country. The brothers Zises, Selig and Jay, financed the company with a public offering in 1968. Together they now have Integrated Resources stock worth $40 million. Last year their salaries and bonuses exceeded $1 million. That's $1 million each. Like a lot of other people in this trade, they are, essentially, getting rich off money that would otherwise be going to the tax collector.

Not surprisingly, Integrated Resources has lots of emulators. Some are sleazy. Some are highly respectable, like the insurance companies rushing into the market: John Hancock, Penn Mutual, Travelers and many others. The insurance boys won't be nearly as wild and woolly in their private syndications—and they will mainly offer "public" deals—but their arrival and the further influx of capital will help force up real estate prices and drive already low income returns even lower. When the elephant gets into one end of the pool, the water rises all over.

Tax shelter sponsors and planners at Las Vegas

What merchandise is moving best? There is no question—real estate. For every dollar going into oil and gas deals, two dollars now go into real estate syndications.

For now, the real estate syndication sponsors see only a rising sales curve and fat profits. The syndicators are getting rich. There's Balcor Co., whose founders sold out 18 months ago to Shearson/American Express for over $50 million after starting from scratch only ten years ago. Now Jerry Reinsdorf, former IRS tax lawyer and one of seven cofounders (in 1973), has a tax problem. What does he invest in? Real estate? He raised $19 million in a 50-person limited partnership to buy the Chicago White Sox in 1981. That partnership was strictly for his fellow Balcor executives and a few well-heeled investors like commodity trader Richard Dennis. It has paid off in spades for them, as they helped turn a subpar baseball franchise into a division winner in only two years.

Balcor is no fluke. There's Equitec Financial Group, Inc., which went public this summer and now has a market value of $64 million. There's First Winthrop Corp., a Boston-based packager of private deals that is negotiating to buy a long list of Manhattan properties, including the Gulf & Western office building, from the MacArthur Foundation. (Lots of money at stake, several hundred million, and lots of potentially syndicatable properties there.) And there's Craig Hall, who bought his first real estate property when he graduated from high school 15 years ago in Ann Arbor, Mich. By the time he was 22 he was a millionaire. Today he has 85 real estate syndications, which include the recent $51 million American Motors headquarters sale and leaseback deal in Southfield, Mich.

Sole owner Hall, now 33, is himself surprised by the degree of his success: "We now have over $1 billion worth of property, and I guess that is a bigger number than I thought existed."

Even when the stock market is busy, brokers make time these days to get on the telephone and push syndication and realty tax deals. In addition to selling packages for other syndicators, some of the brokers are packaging their own. Merrill Lynch, for example, this past spring closed on a single "public" deal, raising $250 million through Merrill Lynch Hubbard Inc. in just one month. E.F. Hutton is especially active. A recent Hutton offering, cosponsored with W.P. Carey & Co., anticipates such a rush of investors that built into the $40 million deal is an option to raise another $40 million as necessary.

The present passion for real estate deals leaves even some interested observers more than a bit uneasy. Surveying the state of the deep tax shelter syndication business today, for example, Douglas Weil, president of Paine Webber Properties, put it this way to an industry seminar: "We may be doing deals good, but I'm not sure we're doing good deals."

Internal Revenue agrees. It is trying to get Congress to disallow accrued but unpaid interest as a tax deduction. If that happens, good-bye triple writeoffs, good-bye most of the customers.

As a hedge against this potential crimp in their livelihoods, some real estate packagers are bringing out public—that is, income-oriented—real estate deals.

Even those nice, safe income deals, the "public" syndications, deserve a closer look. Newsletter Editor Wetterer recently analyzed the completed offerings of five large public syndicators over the past eight years. They are a good sample: 158 property sales in different parts of the country with a worth of $800 million, held an average of 5.7 years.

What did he find? The value of the properties, after deducting direct buying and selling costs, capital improvement costs and discounting for notes taken instead of cash, returned a compounded average yield of less than 6% a year. Granted, on a total return basis, including tax savings and cash flow, the reward works out to 11% to 12%. But that's a long way from the 20% or more that a good many investors had been led to expect. And that, mind you, in a period when inflation was rampant and real estate was in a roaring bull market. "The results surprised me," says Wetterer. "I figured the properties would have shown better gains."

Investors also will suffer financially if they have to sell out early. They will be lucky to recoup their original investment, and often must settle for 10% less. There is no such thing as liquidity in syndicated realty deals, neither of the tax nor income varieties.

The bottom line? Remember that the tax shelter boys held their convention at the Las Vegas Hilton. As anybody who's been to Las Vegas can tell you, the best way to double your money in that town is to fold it over and put it in your pocket. The same with most real estate tax shelter schemes. ■

Pennsylvania Securities Commission,
Philadelphia, Pa., February 24, 1984.

Re Fraudulent and abusive securities tax shelter offerings.

Ms. Maureen Thompson,
Rosapepe, Powers, & Spanos,
Washington, D.C.

Dear Ms. Thompson: On behalf of the North American Securities Administrators Association (NASAA) Real Estate Investments Committee, I am submitting proposals for amendments to the Internal Revenue Code of 1954, as amended, (Code) designed to reduce fraudulent and abusive tax shelter securities offerings. The list is by no means exhaustive but represents certain of the key factors which have come to the attention of state securities administrators and their staffs in their review and investigation of tax shelter securities offerings.

I.—ISSUE

The figures are staggering as to the number of actual and potential cases the Internal Revenue Service (IRS) is involved in which relate to fraudulent securities offerings. The IRS has acknowedged that its personnel limitations prevent it from effectively dealing with more than a small percentage of its caseload.

Recommendation

Section 6103 of the Code should be amended to permit the IRS to share information with State securities investigators where the IRS has reason to believe that a tax shelter securities offering may be fraudulent. NASAA members are willing and anxious to cooperate in any investigations involving securities fraud. This additional source of manpower and resources could make substantial inroads both as a deterrent and as an enforcement vehicle against fraudulent tax shelter securities offerings.

II.—ISSUE

Projections or forecasts included in the offering material of many tax shelters demonstrate that the offerings present little, if any, opportunity to produce economic gain and appear to be motivated for tax purposes. See Examples I, II and V in the attached memorandum of James J. Craig, Chief Accountant to the Pennsylvania Securities Commission, dated January 25, 1984 (Memorandum).

Recommendation

Section 165 of the Code which, *inter alia,* limits losses to those entered into for profit should be tightened to limit the availablity of tax losses in those offerings which have no reasonable expectation for economic profits within ten years. The Memorandum illustrates this point because, based on projections provided by the issuers or sponsors no economic gain (as opposed to tax savings) are anticipated until many years in the future.

III.—ISSUE

A major concern is the artificial nature of excessive deductions relating to debt obligations. The use of the accrual method at the partnership level creates a method for enormously increasing deductions for interest expenses not currenty paid by the taxpayer. The problem is discussed further in Footnote 4 to the Memorandum.

Recommendation

The timing and calculation of deductions should relate to the economic reality of the transaction. Section 1232(a)(c) of the Code already provides in the case of original issue discounts on corporate debt securities that annual interest *income* is imputed. An analogous treatment of *expenses* would result in a realistic relatinship between the timing of the deductions for expenses and actual out-of-pocket payment of the cost upon which such a deduction is predicated.

IV.—ISSUE

Many securities offerings involve "incentive fees" being paid to the general partner. Since the general partner is not required to perform any additional services to earn the fee and since the fee is based upon the profits of the partnerships, the "incentive management fees" appear to be a means by which the general partner shares in the profits of a limited partnership while attempting to create a deduction based upon the theory that the fee is for a service.

Recommendation

Section 703 of the Code should be tightened so as to permit deductions for fees to the general partner based solely on the reasonable value of services performed and additional incentive management fees based upon the profitability of the partnership should be treated as distributions to the general partner and not as a deductible expense.

V.—ISSUE

Many real estate transactions attempt to increase immediately deductible fees by creating artificial performance guarantees by the seller of the property with respect to such features as rent ups and cash flow. Additionally, initially deductible fees are created through covenants not to compete. In reality, these transactions are designed to reduce the selling price of the property from its fair market value to a lesser figure. However, the difference is made up by the payment to the seller of these fees. Since these fees are readily deductible, whereas the cost of property can only be depreciated such arrangements produce unrealistic tax results.

Recommendation

The Code should provide tht such arrangements between the seller and the purchaser constitute a joint venture and as such the fees would not be initially deductible.

Very truly yours,

Robert M. Lam, *Chairman.*

Statement of Belinda J. Dunmire, Pittsburgh, Pa.

Increasingly popular as vehicles for the transfer of wealth or as an income shifting vehicle, the "Crown Loan" or "Crown Trust" arrangement permit the grantor to transfer income to a beneficiary/recipient without having to part with any capital. Since 1978 when the case of *Lester Crown* v. *Commissioner,* 585 F.2d 234 (7th Cir. 1978) was decided, these "Crown" arrangements have been an effective tax avoidance mechanism and had neither been held to be subject to a gift taxability, or to income taxability to the grantor (Note: last week's Supreme Court decision in *Dickman et al.* v. *Commissioner* has now rendered Crown trusts subject to gift taxability). Congressional action is needed to clearly impose proper income and gift taxability in these situations and to disassemble a tax shelter which has permitted wealthy individuals to shift and shield significant amounts of income from taxation. Eliminating the easy availability of tax free Crown Trusts could be an important source of additional revenues to the Federal Budget.

To establish and fund such a trust creating a net increase to intra-family wealth, the transactions undertaken are quite basic. First, the grantor borrows money from a bank predicated on either currently available collateral or earning power. Typically, the bank structures the loan such that the grantor pays the interest alone, the principal remaining unpaid. Therefore, the loan approval can be based merely on the grantor's ability to service the debt, not on his ability to repay the principal.

Secondly, an irrevocable *Clifford* type trust is created to which the grantor relends the money borrowed from the bank. The loan to the trust is evidenced by a *non-interest bearing demand note.* It was the case of *Helvering* v. *Clifford,* 309 U.S. 331 (1940) which outlined the rules that must be followed for a donor to successfully transfer an *income* interest to a donee beneficiary. The donor must transfer the principal of the asset to a trust which has a term of more than ten years or for a term which is not likely to end before ten years. To create an effective *Clifford* trust, the donor must relinquish complete control of the asset over to the trustee thereby making a gift to the beneficiary of the value of *income* the trust can earn. In order to simplify the taxability of these trusts, the Internal Revenue Service has established tables based on an "average" rate of return of 6% yearly.

The third step in establishing the *Crown* arrangement is that the trustee uses the entire amount loaned to the trust by the donor with an interest free demand note to purchase high quality securities. The trustee subsequently collects income from the investments and pays the income to the designated beneficiary of the trust in accordance with the terms thereof. Typically, the beneficiary will pay income tax on the trust proceeds at a substantially lower rate than that to which the grantor is subject. The grantor, in turn, is able to deduct his interest payments on the original bank loan from his own income for tax purposes.

The Crown trust has been an easy mechanism for generating additional after-tax dollars for a household by establishing such a trust for a beneficiary who is a minor, or between two or more intra-family taxpayers in widely diverse income tax brackets. The income is shifted for taxable recognition to the lower bracketed taxpayer recipient while creating an interest expense deduction for the higher bracketed taxpayer donor. These trusts can and do create significant intra-family gain, the taxability of which needs to be clearly established by congressional act.

GIFT TAXABILITY

The federal gift tax is an excise tax levied on the right to give away property or money during life (I.R.C. § 2501(a)(1). It is the *transfer* of wealth which triggers taxability and the tax, which it is the donor's responsibility to pay, applies to all transfers whether direct, or indirect, for property that is real or personal, tangible or intangible. The present gift tax provisions were enacted by the Revenue Act of 1932 and the Congressional Committee reports reflect Congress' intent to broadly reach any gratuitous transfer of any interest in property. H.R. Rep. No. 708, 72nd Cong., 1st Sess. 27-28 (1932), reprinted in 1939-1 Cum. Bull. (Pt. 2) 457; S. Rep. 665, 72nd Cong., 1st Sess. 39 (1932), reprinted in 1939-1 Cum. Bull. (Pt. 2) 496. See also Treasury Regulation § 25.2511-1(c), 26 C.F.R. (1981) which embodies the same expansive action. Further, on several occasions the Supreme Court has indicated that the gift tax provisions should be applied broadly to effectuate the clear, sweeping intent of Congress. *Commissioner* v. *Wemyss,* 324 U.S. 303 (1945), *Robinette* v. *Helvering,* 318 U.S. 184 (1943), *Smith* v. *Shaughressy,* 318 U.S. 176 (1943).

As noted earlier, the Supreme Court last week in the case of *Dickman et. al.* v. *Commissioner,* [No. 82-1041, 22 February 84 on appeal from 690 F.2d 812 (11th Cir. 1982)] that an interest free loan of funds is a "transfer of property by gift" within the contemplation of the Code and is therefore subject to federal gift taxation. The taxable gift was held to be the "reasonable value of the use of the money lent", or in other words the gift consists of some unspecified rate of interest—the donee having the benefit of the loan interest free.

Certiorari was granted by the Supreme Court in *Dickman* to resolve conflicts between the circuit courts as to whether intra-family interest-free demand loans resulted in taxable gifts of the value of the use of the money lent. The conflicting decisions referred to were between the 7th Circuit in *Crown* v. *Commissioner* (from whence "Crown Trusts" emerged) and the 5th Circuit in *Republic Petroleum Corporation* v. *U.S.,* 3/12/80, 5th Cir.) on one hand, the 11th circuit decision in *Dickman* on the other. In *Crown,* the 7th Circuit held that there was no evidence presented to show that the demand note was worth less than its face value amount and therefore constituted a legitimate debtor-creditor relationship—hence no gift. The court also stated, unlike the 11th Circuit in *Dickman,* that the use of money "at will" (as in a demand note) is not "property" for gift tax purposes. The fact that the note could be called at any time with no specified term and the fact that no interest was required were both important to the *Crown* court, and it went on to say that it was insufficient for the Commissioner to show that there were good policy reasons for taxing such a transfer.

The 11th Circuit decision in *Dickman* was affirmed by the Supreme Court thereby overruling the *Crown* case. However, the mere fact that such a direct conflict existed just below the Supreme Court level should be reason enough to justify the codification of last week's decision in *Dickman* into the federal tax law thereby clearly and unequivocally establishing the gift taxability of Crown trusts. Note also that the two dissenting justices in *Dickman,* Justice Powell and Justice Rehnquist, asserted that the gift taxability of interest free loans was a matter for Congress, not the judiciary. This assertion, despite the holding in the case, should not be ignored.

Caveats which should be considered are, first, that the Tax Court and the I.R.S. treat a loan made in exchange for a term note which bears an interest rate lower than the currently prevailing rate for similar loans as a transfer in exchange for inadequate consideration and, therefore, taxable as a gift. The amount considered to be the taxable gift is the difference between the amount loaned and the fair market value of the notes given in exchange. *Estate of Meyer B. Berkman* v. *Commissioner,* T.C. Memo 1979-46; Let. Rul. 7905090. Further, there is an obvious difficulty in determining a proper value and interest rate on which to impose gift taxability for Crown trusts under IRC § 2512(a) and Treas. Reg. Sec. 25-2512-9, Table B. It is generally agreed that the 6% interest imposed by the I.R.S. on *Clifford* Short-Term Trusts is far too low, and this, added with the valuation difficulty in interest free Crown loans should be a cue for Congress to additionally establish a statutory interest rate upon which to value the gift in question. A 10% or 12% statutorily imposed interest rate to determine gift taxation in these trusts would be appropriate considering current investment return availability.

Secondly, although all intra-family transfers are deemed to be gifts, there is now an unlimited marital deduction for gifts between spouses, such gifts being exempt from taxation. Additionally, there is a $10,000 annual exclusion for gifts between a parent and child, that being increased to $20,000 if both parents join in the gift. Transfers for tuition and medical care are not traxable. These generous provisions in the tax code, thereby exclude a significant yearly gifted amount from taxability, Ergo, for example, a parent could still, using a Crown mechanism, lend $100,000 to the trust and at 10% return, the $10,000 of income to the child would still be tax exempt under the exclusion. Beyond the annual exclusion, a gift value will be calculated into the present "unified credit" of the estate tax and until the amount is "used up" (currently $96,300 in estate tax credit for 1984) no gift taxability will result. Note also that a grantor might choose to pursue a gifting program with the trust, forgiving $10,000 of the note's principal balance yearly ($20,000 if joined by both parents) which would also be figured into the unified credit amount if together with the interest the total exceeded the maximum annual exclusion. In this way, a grantor may permanently transfer a substantial amount of capital over the trust term.

This shows that it is the extremely wealthy donor who most benefits from the tax shelter of the Crown transfer. It is important therefore to not only codify the *Dickman* decision but also to consider the income tax aspects of the Crown trusts.

INCOME ALLOCATIONS FOR TAXATION

Unlike gift tax aspects of a Crown trust, assertions by the I.R.S. that income should be allocated to the donor rather than the donee in these situations have been lost on every test of those positions in federal appeals court. The issue has not come before the Supreme Court. Therefore it is an absolute necessity that congressional action be taken in this area to effect income allocations to the donor for the trust income. By shifting the income allocation to a lower bracket taxpayer/family member from the higher bracket taxpayer/family member intra-family gain results due to the lower income tax liability of the beneficiary. The taxable income of the high-bracket taxpayer is reduced at the expense ultimately of all other taxpayers and the government. (See example of figures on attached appendix). The gift tax imposition now helps offset that revenue loss, but with the annual exclusion the result is slight.

The court in *Clifford* outlined, as discussed above, the circumstances under which the income of a short term trust would be allocated to the donee. In *Crown* situations, the term requirement of 10 years is clearly missing as the nature of the demand note allows the donor to recall the entire trust corpus at any time. The donor clearly does not relinquish dominion and control over the trust assets, therefore any income generated by those assets *should be assigned to him.* Legislative intent has been and continues to be that the "fruit" of an individuals property or labors be income attributed to that individual and be taxable as such. The additional taxes generated by allocating Crown trust income to the donor rather than the donee would be substantial. This vehicle by which high bracket taxpayers reduce their tax liability is an evasion of taxation not tax avoidance and a provision of the tax code is mandated to fill this loophole in the system.

APPENDIX—COST/BENEFIT ANALYSIS OF THE INTEREST FREE LOAN ARRANGEMENT

Percent						
Interest rates[1]	Grantor's tax bracket[2]	Grantor's net cost[3]	Beneficiary's income tax[4]	Total family cost	Beneficiary's income	Family's income position change
8–10	25	$7,500	$1,100	$8,600	$8,000	($600)
	35	6,500	1,100	7,600	8,000	400
	45	5,500	1,100	6,600	8,000	1,400
	50	5,000	1,100	6,100	8,000	1,900
9–11	25	8,250	1,290	9,540	9,000	(540)
	35	7,150	1,290	8,440	9,000	560
	45	6,050	1,290	7,340	9,000	1,660
	50	5,500	1,290	6,790	9,000	2,210
10–12	25	9,000	1,495	10,495	10,000	(495)
	35	7,800	1,495	9,295	10,000	705
	45	6,600	1,495	8,095	10,000	1,905
	50	6,000	1,495	7,495	10,000	2,505

APPENDIX—COST/BENEFIT ANALYSIS OF THE INTEREST FREE LOAN ARRANGEMENT—Continued

Percent		Grantor's net cost[3]	Beneficiary's income tax[4]	Total family cost	Beneficiary's income	Family's income position change
Interest rates[1]	Grantor's tax bracket[2]					
11–13	25	9,750	1,715	11,465	11,000	(465)
	35	8,450	1,715	10,165	11,000	835
	45	7,150	1,715	8,865	11,000	2,135
	50	6,500	1,715	8,215	11,000	2,785
12–14	25	10,500	1,939	12,439	12,000	(439)
	35	9,100	1,939	11,039	12,000	961
	45	7,700	1,939	9,639	12,000	2,361
	50	7,000	1,939	8,939	12,000	3,061
13–15	25	11,250	2,169	13,419	13,000	(419)
	35	9,750	2,169	11,919	13,000	1,081
	45	8,250	2,169	10,419	13,000	2,581
	50	7,500	2,169	9,669	13,000	3,331

[1] Rate for investiment and loan respectively.
[2] Grantor's marginal tax bracket as shown.
[3] Assumes a loan of $100,000.
[4] Beneficiary's tax assumes no other income and that Grantor maintains the dependent's $1,000 annual exemption.

ENGLER, ZOGHLIN, MANN, LTD.,
Wilmette, Ill., February 24, 1984.

To the Members of the House Ways and Means Committee:

GENTLEMEN: Our comments on the matters concerning proposals set forth for Committee consideration represent our experience as practitioners working in the area of employee benefit plans with a wide range of corporate clients.

While 501(c)(9) trusts have been used as welfare plan vehicles since 1926, they did not become practical for small and medium sized employers until the Treasury Department published final regulations in January of 1981. The impact of the final regulations was significant in that it gave employers and practitioners a set of rules to follow in the design and administration of 501(c)(9) trusts. Prior to that, the absence of regulations effectively precluded this class of employers from using this type of plan. Unfortunately, while the promulgation of final regulations was expected to provide a set of guidelines for the use of VEBA's, in fact, the Exempt Organizations branch of the Internal Revenue Service has subsequently superimposed additional criteria for exempt status, and consequently left employers attempting to establish VEBA's in a state of confusion and uncertainty. We therefore welcome Congressional attention in this area to hopefully clarify this situation and allow employers to utilize VEBA's as an effective means of providing legitimate employee benefits.

First, it has been suggested that the "committee may wish to consider to what extent favorable tax treatment of employer contributions to welfare benefit plans, relative to payments for wages and salaries, is appropriate in view of the favorable tax treatment also provided when the employees received the benefits", in light of the fact that "payments of medical, certain disability, certain life insurance, legal services, dependent care assistance, and other benefits are excluded from the employees gross income in contrast to the treatment for wages and salaries." We would like to stress the social desirability of providing welfare benefits and the corresponding need to encourage employers to do so. The fact that these benefits have been consistently considered socially desirable is the reason that historically they have not been taxed to the individual. A consideration to tax benefits such as medical payments or contributions for medical insurance would represent a significant departure from this historic public policy. Indeed, the provision of such benefits represents essential and basic protection in the same category as food, clothing and shelter. Indeed, there would be very few families in the United States who could stand to pay a medical bill if it weren't for the security provided by employer sponsored insurance. To discourage employer funding of such welfare benefits would be counter-productive to achieving these universally recognized social goals.

Secondly, it has been suggested that the "committee may wish to consider to what extent the availability of favorable tax treatment for contributions to welfare benefit plans reduces the incentives for employers to maintain qualified pension plans, which must satisfy far more restrictions to obtain similar tax treatment. The favorable treatment of the latter is often viewed as an incentive for employers to satisfy the various conditions intended to protect plan beneficiaries which are required for plan qualification. Under present law, the availability in a welfare benefit plan of similar tax treatment with fewer employee protections may undermine the incentive." We would comment on this issue by asking a series of questions. Does this mean that in all cases retirement benefits would be considered more desirable than welfare benefits? Whose choice should this be? Cannot both incentives exist together? If the primary concern is similar tax treatment, why not make employer protections equivalent when providing each type of benefit and not favor one incentive over the other? Employees value many welfare benefits at least as highly as pension benefits and are just as interested in the amount and quality of both types of benefits as they are in the amount of their take-home pay.

In fact, from a tax shelter point of view, a qualified pension plan is a much more attractive vehicle to an employer than a VEBA. A Section 501(c)(9) Trust does not allow for any deferred compensation arrangements, loans, favorable tax treatment of distributions, portability or reversion of assets to employers. Indeed, given the Treasury's most recent interpretations of the regulations concerning VEBA's, a qualified pension plan would allow an employer significantly more freedom in providing benefits than would a VEBA. It is important to note that different benefits are being provided under a qualified pension plan, as opposed to a VEBA. Just as the VEBA regulations prohibit deferred compensation, so qualified retirement plans are effectively prohibited from providing medical coverages. The fact is that the vehicles are designed to provide different kinds of benefits, not a single kind of benefit to the exclusion of another.

Thirdly, it has been suggested that the "committee may wish separately to consider the two basic elements of the favorable tax treatment for contributions to welfare plans. It may wish to consider rules which would allow deductions for those contributions only at the time the benefit is paid rather than at the time the contribution is made, and it may wish to consider restricting the use of tax exempt entities through plans that (1) satisfy nondiscrimination requirements and (2) do not pay benefits which are essentially equivalent to wages or to deferred compensation." To deal with this suggestion, we must investigate the rationale for any employer to set up a 501(c)(9) trust. All employers who provide any type of employee benefits are consistently faced with the problems of uneven business activity, varying profits and inflating costs (especially in the medical benefits area). One of the primary reasons for the interest and acceptance of 501(c)(9) trusts is that they represent a method for an employer to level his costs and provide for a reserve in order to insure that benefits can be continued in times of economic dislocation. The economic safety net provided to employees through benefit plans can be as important as the wages and salaries paid to those employees. It is essential for the retention and attraction of employees to make sure that safety net remains in place. If an employer has the ability to level its costs using actuarial methods so that he can accurately predict cost levels into the future, it has the opportunity to efficiently provide benefits on an ongoing basis. If deductions for contributions to a 501(c)(9) are limited to benefits paid, this effectively throws the employer back into the position of currently funding benefits, in the face of increasing costs and inflation, whether its business activity warrants it or not.

It is reasonable that VEBA's be required to satisfy non-discrimination requirements, as well as be required to limit benefits to those which are not deferred compensation. These types of requirements have existed in qualified pension plans since their inception and certainly could be applicable to 501(c)(9) plans.

Indeed, a reading of the staff pamphlet would indicate that VEBA's are being used primarily for the provision of severance pay and ski chalets, when in fact the predominant use of VEBA's has been to provide the benefits specified in the regulations, i.e., life insurance, medical insurance, disability coverages, sick pay, child care facilities, supplemental unemployment compensation benefits and personal legal services. We see a great danger in focusing on the most extreme perceived abuses of available favorable tax treatment and fear that under the proposals of the government will be overlooking and devaluing the great majority of plans which are providing necessary and valuable benefits to employees. In focusing on these extreme examples, we find the proposals in their specifics to be unduly harsh and administratively unfeasible. Under the proposal, not more than 25% of the benefits provided annually under a VEBA can be provided to officers, owners or highly compensated employees. The 25% test for discrimination does not exist anywhere in law or IRS regulations. Furthermore, we don't quite understand how such a test would be made. For example, suppose an employer with 10 employees maintained a 501(c)(9) for medical benefits. the owner/member suffers a stroke which results in a $100,000 medical bill and reimbursement by the 501(c)(9) trust. If the other 9 employees don't qualify for comparable benefits, the owner/member would have violated the 25% rule and therefore disqualified the plan. If the same medical plan existed outside of a VEBA and the same situation occurred, the owner/member would have had a deductible contribution and a non-taxable benefit paid to him without violating any arbitrary standard. If such a rule were applied to qualified pension plans, it might mean that the owner, shareholder or highly compensated employee could never retire unless common law employees retired at the same time.

If the above situation occurred, the proposal holds that the VEBA would lose its tax exempt status and the benefits would be includable in the gross income of a highly compensated employee thus making the entire benefit paid out by the VEBA taxable to the employee. This appears to be an extremely harsh and punitive result.

ALTERNATIVE PROPOSALS

We offer the following as alternatives to the staff pamphlets proposals:

1. Amount and timing of deductions.—The funding of a 501(c)(9) trust in virtually all situations represents a calculation based on the expected costs to provide a particular employee benefit. We agree that possible abuses can occur where large deductions are taken in a single year to fund benefits not payable for a long period into the future. We believe that 501(c)(9) trusts should be required to fund benefits in an actuarially sound manner, primarily on a level funding basis. This means that the amortization of future benefits would be done on an even annual contribution basis taking into account expected earnings on funds. This is the predominant method used in calculating future pension benefits and effectively precludes overfunding of plans in early years in order to gain unreasonable contributions and deductions. This would be an acceptable method of funding a plan and would insure that funds would be available to participants when benefits are to be paid. The proposal effectively requires a pay-as-you-go basis saying that deductions can be taken only when benefits are paid. If pension plans were funded on this basis, in many situations, pension benefits would not be available at the time of retirement because prefunding would have been prohibited. Level funding also establishes a reserve on a long amortization basis which would do away with a limitation on reserve requirement as proposed by the staff.

2. Nondiscrimination rules.—Section 501(c)(9) calls for benefits based on uniform nondiscriminatory formulas. Similar formulas are used in the calculation of benefits under qualified pension plans and are used in calculating the actual benefit an employee receives under a vacation pay, sick pay or disability arrangement whether it be within a 501(c)(9) or not. If a percentage test such as the one proposed by the staff were used, a company could float in and out of exempt status depending on economic conditions and the level of staffing in a given year. Thus, a company could be within the percentage at the beginning of a plan, reduce staffing and therefore become disqualified during times of economic recession, and then build back up in times of recovery to meet the test. Thus, there would be no assurance of maintaining exempt status and therefore, a test based on percentages would be unworkable over the typical life of a 501(c)(9) trust. Existing rules such as uniform nondiscriminatory benefits based on compensation as used for qualified pension plans have proved to be nondiscriminatory over time. It seems to us that those rules, which have been used and refined over many years, should be made applicable to 501(c)(9) trusts.

Additionally, items such as eligibility to participate and availability and utilization of benefits should be treated within the existing qualified pension rules so that benefits can not be denied to legitimate fulltime employees. We would not, for example, object to certain benefits (i.e., severance benefits) being subject to required vesting similar to that in qualified pension plans. VEBA regulations already have more stringent provisions dealing with plan terminations than pension plans, providing that excess assets cannot revert to the employer, but must be allocated among plan members at the time of termination. We would suggest that a plan member in a 501(c)(9) be considered a member for purposes of allocating benefits on plan termination even if he had severed employment within the two years prior to any termination.

We would hope that the committee, in considering possible changes to the rules affecting Voluntary Employee Beneficiary Associations, recognizes the unique role that such organizations can play in delivering welfare benefits and attempts to fashion guidelines which will encourage and promote the viability of these organizations. We feel strongly that the staff proposals under consideration are designed to negate the use of this vehicle by most employers. If that is the case, the Treasury, in its efforts to increase revenue, is doing so at the expense of the millions of employees who depend on these welfare plans for their well-being.

Very truly yours,

GILBERT G. ZOGHLIN.

FELT PRODUCTS MANUFACTURING CO.,
Skokie, Ill., February 24, 1984.

Gentlemen:

Our company which is located just north of Chicago manufactures automotive parts for original equipment and aftermarket sales. We employ about 1,600 people and operate out of just one location.

Felt Products has had a VEBA for many years which has acted as protection for its participants in the event that our company fell on hard times. Included in the VEBA are health benefits (which are self-funded) and many others.

We understand that there are to be discussions in the House Ways and Means Committee pertaining to VEBA in general. We sincerely hope that you will do whatever is possible to make sure that VEBA's are not negatively impacted.

Sincerely,

DAVID WEINBERG.

INTERSTATE NATIONAL GAS ASSOCIATION OF AMERICA,
Washington, D.C., February 28, 1984.

Re Tax Proposals Included in the President's Fiscal 1984 Budget.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
Washington, D.C.

DEAR MR. CHAIRMAN: The Interstate Natural Gas Association of America (INGAA) is a nonprofit national trade association whose membership consists of virtually all of the major interstate natural gas transmission companies in the United States. INGAA's members transport approximately 90 percent of the natural gas that is sold in interstate commerce. All of its members are subject to regulation by the Federal Energy Regulatory Commission (FERC).

DEFICITS AND THE RECOVERY

INGAA believes that the projected Federal deficits are a major national problem that must be remedied. The Federal government must exercise considerable restraint on spending in the next several years if any meaningful reductions in the deficit are to occur. The deficits in each of the next three years are expected to be about $200 billion. This will average out to about 5 percent of GNP. We believe that the Federal Reserve may ultimately accommodate the Treasury's enlarged borrowing needs by stepping up its purchases of government securities. This in turn would accelerate growth in the money supply and increase inflationary pressures within the economy. In the absence of an accommodative Federal Reserve policy, Federal debt sales would displace private investment. The Treasury would use funds that could otherwise be available for private investment. Reduced private investment would result in smaller additions to the supply of capital goods and thus would reduce the rate of economic growth. Therefore, it is imperative that spending be reduced.

INGAA would make the following observations on several of the administration budget proposals pending before your committee, as well as on one item in H.R. 4170.

INGAA agrees that recapture should not be avoided by the use of partnerships. It also believes that a corporation should not be precluded from reorganizing through the use of a partnership if it so chooses. There is no recapture tax when assets are transferred to a newly created subsidiary which is then spun-off, tax free, to the shareholders of the parent corporation. In the case of a spin-off of a subsidiary or when there is a distribution or sale of a partnership interest, the taint of recapture does and should remain with the assets. The recapture is not avoided. It should occur when the tainted asses is disposed of by the new subsidiary or by the partnership. INGAA does not believe that the perceived abuse is real. Long-standing tax rules adequately provide for recapture at the time the assets are truly disposed of. It should not occur when the transfer is part of the restructuring of a business operation.

DEDUCTIONS

The Administration's proposal claims it would clarify the "all events" test by not allowing a deduction until *economic performance* occurs. However, the concept of when economic performance occurs is a vague standard that will undoubtedly trigger much litigation. Under the proposal a deduction would be permitted when services are performed. Does this mean when services are totally completed, or will a taxpayer be required to accrue a deduction for the portion of services partially performed through the end of the tax year? Moreover, why should a liability for workmen's compensation not be deductible when an employee is injured while performing services and therefore insured under state law? Another uncertainty under the proposal is that a deduction would be permitted when the use of property occurs. Does this mean that reclamation costs for coal operations would be deductible when the mining company uses a specific coal tract?

Another one of our concerns is that the proposal would, to a large degree, undermine the accrual basis of reporting taxable income. Certainly the exception contained in the proposal for cases where economic performance occurs within one year is not adequate. Realistically, if the proposal is to receive serious consideration, an exception period of two to three years would be more appropriate. Without such an extended period, the administrative burden of keeping track of certain liabilities to determine precisely when they are paid would be onerous. In the same vein, we would also suggest that for the exception to be administratively feasible, it should contain a minimum threshold amount such as $500,000, or $1,000,000. In other words, liabilities under the prescribed threshold amount could continue to be currently deducted by taxpayers even though actual payment is made several years in the future. It should also be noted that if the proposal's exception of one year is extended to two or three years, the purported burden now shouldered by the government, due to the time-value of money, would be significantly reduced.

For financial statement purposes, many companies make monthly accruals of estimated annual liabilities even though the payments may not be made until the following year or two. The Administration's proposal would make the tax deductibility of these amounts uncertain and increase the number of book-tax differences that must be kept track of. We sense that from an overall tax policy standpoint, it would perhaps be better to leave to the Courts, the diverse factual and theoretical problems that arise in this area. Not only will enactment of such a broad statute fail to resolve most of the current difficulties, but instead it will probably increase the number of disagreements between the taxpayer and the Internal Revenue Service.

TAX CREDITS

Finally, INGAA would like to comment on one provision of H.R. 4170 of particular importance to our members. INGAA supports the proposed extension of the energy credits but objects to any change in the current rules for utilizing tax credits.

Just a few years ago, energy shortages were common throughout America. Based on Congressional support and legislative encouragement, many INGAA members participated in synfuel and other alternate energy projects. The utilization of energy credits was a key ingredient in planning these high risk projects. Thus, continued availability of the energy tax credits is a welcome indication that Congress still supports these investments.

INGAA opposes uniform credit utilization because it will ultimately reduce capital expenditures for *all* activities. The present rules serve the purpose of assuring that certain incentives remain effective as well as encouraging certain investments over others. To the extent that energy and regular investment tax credits would be subject to the same utilization limits, investment credits from ordinary business activities will reduce the amount of usable energy credits (and incentives) from alternate energy projects. Conversely, to the extent a company has already committed itself to energy credit eligible investments, it may forego making other business investments generating regular investment tax credits if their utilization is not assured.

INGAA believes the complexity of the tax credit rules should not overshadow the fact that Congress made certain credits applicable to 100 percent of tax liability to assure that incentives exist for certain investments. Since this reason still exists, all credit utilization rules should be left alone, especially the energy tax credit rules because their available life is short and they are directed at highly specialized and substantial investments. INGAA believes that projects grandfathered under the existing tax credit extension rules should be grandfathered from any credit ordering as well.

SUMMARY

INGAA is prepared to help develop these proposals with your committee and the staff and to otherwise assist in any way we can. INGAA urges the Congress to make a meaningful effort to relieve projected budget deficits. INGAA appreciates this opportunity to comment on the various proposals pending before your committee. We believe we have made some positive suggestions for your consideration and we would appreciate their incorporation into the Committee record of the hearings on the Administration's budget package.

Respectfully submitted,

JEROME J. MCGRATH, *President.*

STATEMENT OF THE INVESTMENT COMPANY INSTITUTE

On behalf of its members, the Investment Company Institute[1] submits the following comments on the proposals relating to tax shelters and tax-motivated transactions which are currently under consideration by the Committee.

TRANSACTIONS IN MUTUAL FUND SHARES

The Administration's proposal would provide that all losses recognized on the sale or exchange of shares of a regulated investment company would be long term to the extent long-term capital gain dividends were paid on the shares unless the stock was held for more than six months. The proposal recognizes the need to provide an exception from this rule for certain periodic redemption plans.

The Institute believes that the current holding period for the recognition of short-term loss on a sale of mutual fund shares contained in Code section 852(b)(4) is adequate to prevent taxpayers from converting short-term capital gain to long-term capital gain through the acquisition and subsequent sale of the shares of a mutual fund which pays a long-term capital gain dividend. It is our belief that the existing 31 day rule places mutual fund shareholders at a sufficient market risk to limit tax-avoidance potential. The Institute does not believe that this type of tax-avoidance is commonly practiced by the shareholders of mutual funds. We know of no advertising or touting of opportunity by mutual funds to use such a transaction as a tax shelter. The only occurrence of such a promotion that we are aware of has been with respect to the shares of closed-end regulated investment companies where the costs of the transaction are borne by the investor rather than the company.

As demonstrated by the following example, the Institute believes that the existing 31-day rule is adequate to deter the use of mutual fund shares for tax-avoidance purposes under realistic circumstances.

Example

(1) Assume a mutual fund share with a net asset value of $25.

(2) The fund pays a long-term capital gain dividend of $2.50, 10 percent of the net asset value of the fund's shares.[2]

(3) The value of the stock drops to $22.50 following the payment of the long-term capital gain dividend.

(4) A taxpayer with an existing short-term capital gain of $2.50 would be subject to a tax liability of $1.25 on that gain (assuming the 50 percent bracket).

(5) The taxpayer purchases the mutual funds share just prior to payment of the long-term capital gain dividend and sells the share at $22.50 after 31 days.

(6) The tax liability on the long term capital gain dividend is $.50 (20 percent of $2.50).

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[1] The Investment Company Institute is the national association of the American mutual fund industry. Its membership includes 941 open-end investment companies ("mutual funds"), their investment advisers and principal underwriters. Its mutual fund members have assets of about $264.5 billion, accouting for approximately 90% of total industry assets, and have approximately 16 million shareholders.

[2] A survey of a number of representative equity type mutual funds by the Institute indicates that an assumption of 10% capital gain for 1983 would be an average figure for that year, a relatively properous year for equity funds. Attachment A hereto shows the long-term capital gain dividends paid in 1983 by the seven largest capital appreciation mutual funds as a percentage of net asset value.

(7) The conversion of the short term gain to long term gain results in a tax savings of $.75.

(8) Assuming a taxpayer who is an active trader in securities and who could only use a potential short-term loss upon the sale of the mutual fund share of offset other capital gains (having already exceeded the $3000 limit on ordinary income which may be offest by short-term capital losses), a *3.75* percent downward shift in the market would eliminate the $.75 tax savings.

Statistics on the volatility of the stock market (based on the Standard and Poor's Index) over all 31 days periods within the 1983 calendar year show that a 3.75 percent or more shift in the market has been a relatively frequent occurrence.[3] For this reason, we have concluded that the 31 day holding period in Code section 852(b)(4) does put a mutual fund shareholder substantially at risk, so that the purchase of mutual fund shareholder substantially at risk, so that the purchase of mutual fund shares for tax shelter purposes is by no means a "sure thing" for converting short-term gain to long-term gain.

If it were determined (as it was in 1958) that a 31-day holding period does in fact carry with it sufficient market risk to guard against abuse, it might be reasonable to extend the holding period requirement only in those cases in which an investor has attempted to insulate himself from risk of market fluctuation by concurrently taking a short position in marketable securities.[4] Thus, the use of hedging to accomplish a risk-free tax avoidance could be dealt with directly without adversely affecting the mutual fund shareholder who may inadvertently sell his shares within the proposed six month holding period.

The Institute notes one particular circumstance in which the pending proposal may be broader than the actual problem with the result that the applicable rules may be unnecessarily complicated for many cases in which no tax shelter maneuver is involved. Shares in equity mutual funds are frequently sold pursuant to periodic redemption plans. A periodic redemption plan is a preauthorized written agreement whereby a specified number of shares (or a specific dollar amount of shares) is liquidated from a shareholder's account pursuant to an established schedule, usually monthly. Such agreements are indefinite in length and may be changed or terminated at any time by the shareholder. Because shareholders typically reinvest dividends, if the 31-day rule were extended to 6 months, the loss conversion provision would be triggered by periodic redemptions even though the amounts involved would be nominal. For this reason, the Institute supports the proposal to, at a minimum, exclude systematic withdrawal programs from the application of the proposal's six month rule.

CERTAIN DIVIDENDS RECEIVED FROM REGULATED INVESTMENT COMPANIES

The proposal before the Committee would provide that in the case of a regulated investment company 50 percent or more of which is owned by corporations, the test for dividends qualifying for the inter-corporate dividends received deduction would require that at least 95 percent of the fund's gross income be derived from dividends of domestic corporations. Under current law, a regulated investment company's dividend may qualify for the dividends received deduction if at least 75 percent of the fund's gross income consists of dividends from domestic corporations.

By raising the test for qualifying dividends from 75 percent to 95 percent, the proposal would eliminate the element of administrative convenience which was the primary objective of the 75 percent test. Using 95 or 100 percent standard for determining qualifying dividends for corporate shareholders would, as a practical matter, require an exact allocation of the dividend between the portion which consisted of dividend income eligible for the dividends received deductions and the portion allocable to other income. The Institute's statistics on equity-type mutual funds show that such funds generally maintain approximately 8–15 percent or more of their total assets in interest bearing obligations for purposes of liquidity, i.e. to meet the demands of shareholder redemptions.

A requirement of an exact allocation of qualifying dividends by all corporate shareholders in the affected funds could result in substantial administrative inconvenience for the IRS. A fund's readjustment of the percentage of qualifying dividends paid would require that all corporate shareholders amend their own returns to correct the dividends received deduction taken. If upon audit, a fund makes a minor correction in its computation of the dividend portion which is allocable to domestic dividends received by the fund from, for example, 92.4 percent to 91.8 percent, all corporate shareholders would be required to amend their corporate tax returns.

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[3] Of the 250 31 day periods in 1983 which begin and end on a day the stock markets are open, 67 such periods show an upward or downward shift in the Standard and Poor's Index which is greater than 3.75 percent.

[4] By way of analogy, it may be noted that Code section 246(c), which deals with corporations buying and selling shares of stock in other corporations around dividend payment dates, imposes a 15-day holding period requirement generally, but extends the period to 90 days in the case of investments in certain types of preferred stock where the risk of market fluctuation is reduced.

Unless the administrative convenience achieved by the use of the 75 percent for qualifying dividends is to be completely discarded, a reasonable percentage test should be maintained for determining qualifying dividends for corporate shareholders. In light of the reasonable cash requirements of mutual funds, we suggest the use of an 85 to 90 percent test for qualifying dividends paid to corporate shareholders if the current 75 percent test is to be eliminated for corporate shareholders.

The proposal would establish a 50 percent of more asset ownership test [5] for funds which must use the proposed 95 percent test for qualifying dividends paid to corporate shareholders. *All* mutual funds which may pay a qualifying dividend, not just the so-called "corporate cash funds" at which the proposal appears to be directed, would be required to apply the 50 percent asset ownership test. Because many funds have substantial shareholder accounts which are held in nominee or "street" name, these funds may have difficulty in ascertaining the true beneficial ownership of such shares. We suggest, therefore, the adoption of certain rules for applying the 50 percent test which would ease the burden of ascertaining beneficial ownership of the fund's assets. For example, a fund should be permitted to rely upon the accuracy of any information provided to it regarding the percentage of corporate ownership for shares held in nominee name. A presumptive rule with regard to shares held in nominee name the ownership of which could not be ascertained after diligent inquiry would also be appropriate. In addition, a fund should not be required to ascertain the ownership of its assets on more than one occasion in a taxable year.

Although the proposal currently before the Committee states its intention to correct a perceived abuse on the part of those funds which are expressly organized for corporate investors, we note that the proposal would affect mutual funds which receive a substantial amount of dividend income. In light of this possibly unintended impact upon a large segment of the mutual fund industry, we urge careful consideration be given to any proposal which may impose substantial adminsitrative burdens upon both the mutural fund industry and the government.

ORDINARY NONLIQUIDATING DIVIDEND OF APPRECIATED PROPERTY

The Administration proposal would provide for the taxation to the distributing corporation of any ordinary, nonliquidating distribution of appreciated property. The exceptions of present law set forth in Code section 311(d)(2) would, however, be preserved.

The Institute supports the Administration's proposal to retain the existing provision of law which, in Code section 311(d)(2)(G), excludes a distribution of appreciated property in a redemption by a regulated investment company from the application of a tax on the distributing corporation. The Institute urges the retention of this exclusion on the grounds that the exception set forth in section 311(d)(2)(G) does not give rise to tax avoidance or abuse and there are legitimate economic and securities related concerns which justify the retention of the exception.

A mutual fund is required by the Investment Company Act to redeem, at current market value, its outstanding shares upon demand in the form of either the shareholder's proportionate share of the mutual fund's "current net assets" or the "cash equivalent thereof." (Section 2(a)(31) of the Investment Company Act). Thus the Investment Company Act clearly envisions an in-kind redemption to shareholders which may consist of appreciated property.

As a practical matter, in-kind redemptions are rarely used by mutual funds, as most investors prefer to receive the value of their shares in cash. Moreover, an investment company, unlike other corporations, may not use a distribution of appreciated properties, i.e. securities, as a planned method of tax avoidance. A mutual fund is continuously offering its shares for sale and must redeem its shares upon demand. A mutual fund cannot therefore, engage in a tax-planning scheme through which a corporation may, in a "one-shot" operation, offer its shareholders the right to redeem their shares for appreciated property. There is no evidence to our knowledge that redemptions by mutual funds using portfolio securities have been used as a tax avoidance tool. Share redemptions by mutual funds have never been a taxable transaction, given the conduit treatment accorded a mutual fund under Subchapter M, and do not give rise to the tax abuse which is the subject of the Administration's current proposal.

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[5] Although not clear on its face, the Institute has assumed that the proposal would look to the ownership of the outstanding shares of the fund rather than to the total number of shareholders in the fund when applying the 50 percent test.

A mutual fund's ability to redeem shares in-kind serves as an "ultimate safety valve" in a period of severe stock market decline. Under such conditions, the ability to redeem in-kind helps avoid involuntary market pressures caused by mutual funds selling large blocks of stock in a weak stock market. A mutual fund would most likely choose to exercise its option to redeem shares in-kind only in the event of a securities market decline and substantial shareholder demands for redemption. The ability to redeem in-kind would obviate the necessity for a fund to liquidate a significant part of its assets in a panic market. Significant mutual fund liquidations could only further compound the problems of a downward spiraling market.

The recognition of gain by a mutual fund in the event of a redemption in-kind would disadvantage the remaining shareholders of the fund and lead to further portfolio liquidations in an unstable market. If a gain were recognized, the fund would be required to liquidate additional portfolio assets to either pay the tax on the gain or to distribute the gain recognized to shareholders, as required under Subchapter M. In addition, the imposition of a tax or the recognition of a gain by remaining shareholders could trigger further demands for redemptions and the need for further liquidations. Additional liquidations of portfolio securities by mutual funds which, as an industry, hold over $260 billion in securities could have an enormous adverse impact upon the securities markets and the economy.

In light of the potential impact of continuing, chainreaction liquidations of mutual fund portfolios upon the securities market in a time of market panic, the Institute respectfully suggests that further study and advice from the Securities and Exchange Commission be sought before removing the existing exception in Code section 311(d)(2)(G). No significant tax abuse has been demonstrated in connection with this exception and its deletion could eliminate an important economic safety valve.

The Institute wishes to thank the Committee for this opportunity to present its views and offers to assist the Committee in drafting language for any of the specific proposals made above.

ATTACHMENT A.—*1983 long-term capital gain dividends*

[In percent]

Templeton world fund	4.20
Chemical fund	14.70
Aetna variable fund	0
T. Rowe price growth stock fund	2.90
AMCAP fund	0
Massachusets investors growth fund	16.00
Putnam growth fund	16.86

STATEMENT OF KIMBERLY-CLARK CORP.

The purpose of this statement is to express Kimberly-Clark Corporation's concern regarding certain employee benefit matters addressed in the February 17th pamphlet issued by the staff of the Joint Committee on Taxation and being considered by the Committee on Ways and Means this week.

SECTION 401(K) PLANS

The proposed limitation of "hardship" to substantial and unforeseen financial emergencies would be unduly restrictive and represents a significant departure from the current understanding of Section 401(k).

Kimberly-Clark is not aware of employee withdrawals that would be considered abusive. The two most commonly used justifications for "hardship" withdrawals are the purchase of a primary residence and the payment of educational expenses. Neither type of these economically beneficial expenditures would meet the more restrictive hardship limitations being proposed.

The inability to make withdrawals for homes and education would constitute a disincentive to participate in Section 401(k) plans, particularly as to lower-paid employees for whom these expenditures are not luxuries. If participation by lower-paid employees were to fall below certain levels, the plan itself could be disqualified, which would be detrimental to all participants but most particularly to the lower-paid employees. The proposed revision, in effect, discriminates against lower-paid employees and, as such, is exactly contrary to the intent of the law.

At a time when all types of savings are undesirably too low, we should be encouraging savings whenever possible. The proposed changes in the definition of "hardship" are directly contrary to achieving economically sound increased savings.

WITHDRAWAL OF AFTER-TAX EMPLOYEE CONTRIBUTIONS

The proposal to treat withdrawals of non-deductible employee contributions as first coming out of earnings on those contributions would reverse current law that withdrawals first come out of the non-deductible contributions themselves. When combined with the proposed 10% early withdrawal penalty, this change would place substantial restrictions on a participant's ability to withdraw his or her own money, money that was subject to tax *before* it was contributed to the plan. There is no similarity between this case and the case of the individual who contributes to an IRA and thus receives a current tax benefit.

The proposed change would, in effect, impose more severe restrictions on withdrawals than those that existed under the "constructive receipt" rules that were eliminated by the Economic Recovery Tax Act of 1981. If the 1981 changes created unanticipated problems, Kimberly-Clark urges that the law revert to the pre-1981 "constructive receipt" rules rather than adopting the Joint Committee's proposal.

Furthermore, as with the proposed restriction on hardship withdrawals, this proposed change could also decrease the number of lower-paid employees who would elect to participate in plans of this type, thus increasing the likelihood of plan disqualification and providing a disincentive for needed savings. This adverse effect is also discriminatory as to lower-paid employees and is, therefore, contradictory to the intent of the law.

VOLUNTARY EMPLOYEES' BENEFICIARY ASSOCIATION

The proposal would impose a stricter standard on the deductibility of contributions to a VEBA than presently exists under current law absent the use of a VEBA. The proposal accomplishes the stricter standard by requiring an employer's deduction for contributions be deferred until such time that the employee actually receives the benefit.

There is some evidence that certain taxpayers are abusing VEBAs and using them in a manner not contemplated by the Internal Revenue Code. The abuses seem to fall into two categories: (1) the types of property being contributed to a VEBA, and (2) the accelerated accrual of liability. We believe that these abuses, such as the contribution of vacation homes and condominiums to a VEBA, can be cured by limiting the types of property which may be contributed as is presently the case for Individual Retirement Accounts. The abusive practice of accruing for contributions relating to events which do not occur until future years can also be limited. This can be accomplished by limiting the deduction of accruals for contributions to a VEBA to accruals relating to events that actually occur during the taxable year in which the accrual is made and which are in fact paid to the VEBA during the next year.

The current proposal is unnecessary and far too overreaching. If enacted, more than the abuses would be curbed—the very benefits of VEBAs would be lost. This Committee should strive to avoid the unintended denial of legitimate tax deductions relating to VEBAs and in imposing stricter standards for deductions than if no VEBA were utilized at all.

Accordingly, we respectfully submit that these proposals not be enacted.

STATEMENT OF MESA PETROLEUM CO., ON BEHALF OF THE GULF INVESTORS GROUP

I. SUMMARY

Benefits of royalty trusts to shareholders.—A distribution of oil and gas royalties to a royalty trust can be very beneficial to shareholders. Royalty trusts have a strong record of *enhancing shareholder value* over both the long and short term. A royalty trust provides shareholders, in addition to their shares of common stock, with a direct interest in the net profits from a portion of oil and gas properties. Although individual and other shareholders may have to pay taxes upon receiving the distribution of the trust interests, the creation of an oil and gas royalty trust will enhance the value of a shareholder's investment by an amount which will substantially exceed the related tax liability. The creation of royalty trusts may also be highly advantageous to shareholders of mining and timber companies in addition to oil and gas companies.

Benefits of royalty trusts to the economy and capital markets.—The creation of royalty trusts provides a more efficient business structure for many energy companies which is clearly *beneficial to our economy as a whole and our capital markets.* A major goal of U.S. economic policy is to promote the most efficient use of capital. If business operations can be structured in the most efficient manner, a corporation will maximize the value of its stock, and be able to raise capital at attractive rates. This will increase both profits and employment. Greater efficiency and cost effectiveness in the energy industry is also desirable to help achieve U.S. energy objectives.

A well managed energy company should not deplete its oil and gas production base faster than it can replace it. Transferring a portion of a company's production properties to a royalty trust facilities the task of replacing depleted energy reserves. Since a substantial portion of the producing properties remains with the distributing company, its ability to replace reserves to generate the cash needed over the long term for adequate drilling programs will be preserved. In addition, control of the disposition of all of the oil and gas produced from the properties subject to the royalties would remain with the company.

Since distributions to royalty trusts are generally taxable to individual shareholders at ordinary income tax rates of up to 50 percent, the creation of royalty trusts results in an *increase in federal tax revenue.* However, as previously noted, the increased value of a shareholder's investment will substantially exceed the related tax liability.

Piecemeal corporate income tax changes should be avoided by Congress.—Congress is currently considering several tax changes which would discourage needed equity investment and reduce stock market liquidity to the detriment of all investors. Piecemeal changes in fundamental corporate income tax concepts can result in many inconsistencies and distortions and should be avoided.

Proposed tax on appreciation should be rejected.—Congress should reject the proposal to tax distributing corporations on ordinary distributions of appreciated property to shareholders. Since a distributing corporation realizes no gain on the transfer of appreciated property, no tax should be imposed on the distributing corporation. In many instances, the distribution will be taxed at the individual shareholder level on the receipt of these distributions. The imposition of this new appreciation tax would simply result in additional "multiple" taxation which has an adverse impact on capital formation. In particular, the proposal results in the imposition of an excessive capital gains tax burden in many instances.

Proposed basis reduction should be rejected.—Congress should reject the proposal to reduce, by the amount of certain extraordinary dividends, the basis of certain stock held by corporate shareholders. Enactment of this proposal will result in unnecessary multiple taxation, reduce stock market liquidity and aggravate the existing bias in the tax law in favor of debt as compared to equity financing. The arbitrary one year holding period in this proposal would add yet more complexity to the Internal Revenue Code. In terms of the realities of today's capital markets, a one year holding period clearly cannot be considered a short period of time since the performance of portfolio investments is often measured on a monthly or quarterly basis. Corporate investors provide an important source of liquidity to our capital markets which provides discipline and ensures greater efficiency in pricing. Disincentives to corporate equity investment such as this proposal will discourage such investment and reduce liquidity. The tax code, in many instances, encourages the use of debt and this proposal would further encourage highly leveraged capital structures which impair the ability of corporations to withstand adverse economic developments.

Proposed restrictions on the interest paid deduction and dividends received deduction should be rejected.—These proposals relating to corporate indebtedness to purchase stock would also reduce market liquidity, discourage equity investment and raise the cost of capital for many companies. The proposals are inconsistent with recent action by Congress to encourage investors to take the types of *risk* needed to develop new products and processes in order to promote economic growth and to boost productivity.

II. ADVANTAGES OF A ROYALTY TRUST TO SHAREHOLDERS AND TO THE ECONOMY

Description of an oil and gas net profits interest

An oil and gas "net profits interest" is an interest in oil and gas production which entitles the holder to be paid a specified percentage or fraction of the value of oil and gas produced from the property or properties subject to the royalty. The interest can be a percentage or fraction of the gross value or a percentage or fraction of the net profits. As an example, assume a 10 percent royalty on properties which produce oil and gas valued at $1,000 with production costs equalling $200. The royalty payable based upon gross value would be: 10 percent × $1,000 = $100; while the royalty payable based upon net profits would be: 10 percent × ($1,000 − $200) = $80.

Royalty trusts

A royalty trust is created when a net profits interest in identifiable oil and gas properties is conveyed (typically by an oil and gas company) to a trustee. The trustee holds the interest on behalf of numerous individuals and entities who are the beneficial owners of the royalty (typically in proportion to their share of ownership in the company). The trustee delivers to the beneficial owners "units of beneficial interest" which evidence each owner's proportionate interest and disburses the proceeds to such beneficial owners. The trust has no employees and is not engaged in a trade or business other than receiving and distributing income.

Why are royalty trusts created?

Royalty trusts are created in order to increase shareholder value. The shareholders are the real owners of the company and a royalty trust distribution operates to give the actual owners of the company a direct interest in oil and gas properties held by the company.

Based upon past experience, capital markets generally place a higher value on oil and gas reserves when such reserves are in the form of a royalty trust as compared to the value placed on those reserves by the marketplace when such reserves are a part of an integrated energy company. In many instances, the reduction in cash flow attributable to creation of the trust will encourage management to allocate capital towards projects with higher hurdle rates and this will boost company-wide return on investment.

For a number of reasons, including reserve depletion, the market value of stocks in large integrated oil companies is only approximately 40 percent of their true asset value. Creation of a royalty trust substantially increases the probability that the shareholders' interests will be more accurately valued. Changing the valuation equation is advantageous to both shareholders and the corporation. By putting the cash flow from a portion of the declining reserves in trust for the shareholders, management cannot make uneconomical and inefficient use of cash flow derived from those reserves; and the impact of reserve depletion on the corporation is minimized because there are fewer reserves which need to be replenished. *Management is held more accountable for the corporation's remaining cash flow,* and the shareholders have increased income from the royalty trusts. Streamlining a large oil company minimizes the potential for inefficient operation without any significant disadvantages to the corporation, its shareholders, or the country.

Why place the royalties in a trust?

Generally, royalty trusts have numerous properties and thousands of beneficiaries. That is, numerous oil and gas producing properties are burdened with a royalty that is owned by a great many more people than is typical. It is not practical to enter into the real property conveyances for each owner as is usually the case in the conveyance of a royalty. Therefore, the conveyance is made to a trustee who maintains internal records relating to the undivided ownership of the beneficiaries and the proper distribution of the royalty income.

Units of beneficial interest in a large royalty trust are generally traded on a stock exchange

The units are listed and traded simply to provide liquidity to the numerous royalty owners. Usually, oil and gas interests are bought and sold in private transactions. Because a royalty trust involves so many individuals who own a portion of the same property interest covering the same properties, many sales and exchanges take place. Listing on the exchange provides the owners with public information concerning the properties, including reserve data that meets SEC requirements. The trustee engages outside auditors to audit the royalty revenue and disbursements and related financial information. Typically, professsional Wall Street financial analysts publish their opinions as to the value of the royalties.

The specific benefits to shareholders of a royalty trust

A distribution of oil and gas royalties into a royalty trust is extremely beneficial to shareholders. Royalty trusts have a strong record of *enhancing shareholder value* over both the short and long term. A royalty trust provides shareholders, in addition to their common shares, with a direct interest in the net profits from a portion of the oil and gas properties. Although, as previously noted, shareholders often have to pay taxes on the receipt of the distribution of the trust interests, enhancement in value of the shareholder's investment, as well as the increase in income from the investment, which can be achieved by a trust substantially exceeds this related tax liability.

The benefit of royalty trusts to the economy and capital markets

In many instances the creation of royalty trusts provides a more efficient business structure which is clearly *beneficial to our economy as a whole and our capital markets*. A major goal of U.S. economic policy is to promote the most efficient use of capital. Formation of the most efficient structure for a business to operate will maximize the value of the corporations's stock, enable the company to raise capital at the most attractive rates and maximize both profits and employment. A more efficient energy industry will enable the U.S. to achieve its *national energy objectives* in the best manner.

Some income tax aspects of royalty trusts

The initial distribution to a royalty trust is treated as an in-kind dividend and is generally taxed in the same manner as any other dividend. An investment in a royalty trust subsequent to the distribution involves exactly the same investment and tax characteristics as buying a royalty in a private oil and gas transaction, buying a building or buying a piece of land. The holder of an interest in the royalty trust must look solely to oil and gas production to recover his investment.

The creation of royalty trusts will actually increase federal tax revenue since the distribution to the trust is generally taxable to individual shareholders at ordinary income tax rates of up to 50 percent. Annual royalties to unit holders of the trust will also be taxed as ordinary income. Furthermore, the objective of creating a royalty trust is to enhance shareholder value which results in greater capital gains tax collection on dispositions of shares of stock or units in the trust.

III. PIECEMEAL MODIFICATIONS TO MAJOR CORPORATE INCOME TAX CONCEPTS LEAD TO MANY UNDESIRABLE CONSEQUENCES

Piecemeal changes to major corporate income tax concepts can lead to arbitrary investment distortions, new complexity and business uncertainty. These types of changes should only be adopted as part of a major restructuring of the whole corporate income tax system to ensure that all of the provisions are consistent with one another and achieve the objectives stated by Congress. This obviously requires extensive public hearings and very detailed analysis of the probable impact of any changes on all sectors of the economy.

Issues involving the tax treatment of changes in business structure—whether liquidations, partial liquidations, reorganizations, distributions to royalty trusts, transfers to publicly traded limited partnerships or otherwise—are extremely complicated as documented in *"The Reform and Simplification of the Income Taxation of Corporations,"* A Preliminary Report Prepared By the Staff, Committee on Finance, United States Senate, S. Prt. 98–95, September 22, 1983.

IV. CONGRESS MUST REJECT THE PROPOSED TAX ON THE DISTRIBUTING CORPORATION ON ORDINARY DISTRIBUTIONS OF APPRECIATED PROPERTY TO SHAREHOLDERS

As part of the Revenue Proposals in the Administration's Fiscal Year 1985 Budget,[1] "ordinary non-liquidating distributions of appreciated property would be taxed to the distributing corporation as if the property had been sold."

This proposal would have an adverse impact on the economy and should be rejected. A corporation realizes no gain on a transfer of th is nature. Furthermore, in many instances the distribution will be taxed at the individual shareholder level at tax rates of up to 50 percent. An additional layer of tax will unnecessarily impede the free flow of capital in the economy and result in many inefficiencies. Since this type of change raises many fundamental corporate tax policy issues, Congress should defer action on the proposal until it has an opportunity to thoroughly analyze the entire corporate income tax structure.

First, the fundamental rationale for the Supreme Court's decision in *General Utilities & Operating Co.* v. *Helvering,* 296 U.S. 200 (1935) was that the distributing corporation "derived no taxable gain from the distribution" of the appreciated property. The Court said "this was no sale; assets were not used to discharge indebtedness." [2] Where no taxable gain is realized, there is simply no justification for the imposition of a tax. This fundamental and long standing principle in our tax law must not be reversed.

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[1] "Revenue Proposals Contained In the Administration's Fiscal Year 1985 Budget," Department of the Treasury Fact Sheets, February 1, 1984, item 23.

Second, this proposal is particularly troublesome in light of the fact that in many instances individual shareholders will be fully taxed on the receipt of such appreciated property at ordinary income tax rates of as high as 50 percent. Thus, a heavy tax burden will often be imposed even in the absence of new legislation.[3]

Third, this proposal would *remove certain important symmetry* in the tax code. Generally, the transfer by an individual proprietor of his business assets to a newly formed corporation in exchange for all of its stock is not a taxable event. Under section 351(a) of the tax code, no gain or loss is recognized if "property" is transferred to a corporation "solely in exchange for stock or securities in such corporation," and if the transferor or transferors are "in control" of the corporation "immediately after the exchange." [4] In *Portland Oil Co.* v. *CIR*, the court said that the purpose of section 351 is to save the taxpayer from an immediate recognition of gain in instances "where in a popular and economic sense there has been a mere change in the form of ownership and the taxpayer has not really 'cashed in' on the theoretical gain." [5] Likewide, under current law, the distribution of appreciated property by a corporation to its shareholders does not result in a tax on the distributing corporation. These provisions permit the free transfer of capital and provide *symmetry* between certain transfers *into* a corporation by shareholders and certain transfers *out of* a corporation to shareholders. The proposal to tax the corporation on certain distributions of appreciated property to shareholders would unnecessarily *remove this symmetry*. When assets are transferred into a corporation, the shareholders expect the corporation to create wealth and generate value. The retained earnings of the corporation are not taxed to the shareholders. When assets are taken out of the corporation, these assets will no longer provide growth and will no longer increase the value of the corporation. Consequently, there is no justification to tax a *corporate entity* on its shrinkage in size in these types of transactions.

Fourth, the imposition of "multiple" layers of tax discourages investment and impedes the most efficient allocation of capital in our economy. Business entities need the flexibility to restructure operations to reduce production costs and to contribute to overall productivity improvement. The proposed tax on appreciation is completely inconsistent with the investment incentives enacted by Congress in 1981 as part of the Economic Recovery Tax Act (ERTA).[6] The Report of the Senate Finance Committee accompanying ERTA stated that high tax rates "are an important cause of the economic distortion and inefficiency currently induced by the individual income tax" and also stated that reductions in tax rates are "intended to eliminate a substantial disincentive to investment." [7]

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[2] 296 U.S. 200, at page 206.

[3] With respect to distributions in kind to noncorporate distributees, if the value of the distributed property is fully covered by the corporation's current or post-1913 earnings and profits, the distribution is a *taxable* "dividend" to the extent of its fair market value, under sections 301(b)(1)(A), 301(c), and 316. However, if the value of the distributed property exceeds the corporation's current and post-1913 earnings and profits, the regulations state that the distribution is a "dividend" only to the extent of the earnings and profits. (Regs. § 1.316–1(a)(2)). The balance would *reduce the basis* of the distributee's stock under section 301(c)(2), with any excess over basis being subject to section 301(c)(3) and taxed as a *capital gain*.

With respect to distributions in kind to corporate distributees, section 301(b)(1)(B) provides that the "amount" of a distribution to such a distributee is the property's fair market value (determined as of the time of the distribution) or its adjusted basis in the hands of the distributing corporation, whichever is the lesser. The corporate distributee's basis for the distributed property similarly is the lower of the property's value or its adjusted basis (increased by the distributing corporation's recognized gain) in the hands of the distributing corporation (section 301(d)(2)). Having determined the "amount" of the distribution under section 301(b), the distributee corporation must report the part that is covered by earnings and profits as a dividend, and the balance, if any, as a capital distribution subject to the rules of sections 301(c)(2) and 301(c)(3).

Earnings and profits are not exclusively defined in the tax code. Section 312 of the tax code does provide, however, certain special rules for the computation of earnings and profits. In general, earnings and profits can be computed by making certain adjustments to taxable income. Added to taxable income are items like interest on State and municipal obligations and certain other amounts exempt from tax. Also added to earnings and profits are life insurance proceeds and compensation for injuries or sickness received with respect to employees or others. Certain deductions allowed in computing taxable income are not allowed in computing earnings and profits. For example, the tax code expressly limits accelerated depreciation deductions in computing earnings and profits (section 312(k)). Other deductions limited or denied in computing earnings and profits are the dividends received deduction and the net operating loss and capital loss carryover deductions. Finally, certain deductions not permitted in computing taxable income are allowed in computing earnings and profits. Dividend distributions, Federal income taxes paid, interest deductions disallowed under section 265, excess charitable contributions, excess capital losses and payments disallowed under section 267 are allowed as deductions in computing earnings and profits.

[4] Under sections 351(a) and 368(c), the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

[5] Portland Oil Co. v. CIR, 109 F. 2d 479, 488 (1st Cir.).

Fifth, the issues concerning the taxation of a corporation on the distribution of appreciated property are similar to the issues concerning the taxation of corporate acquisitions and corporate liquidations. The recent report of the staff of the Senate Finance Committee entitled "The Reform and Simplification of the Income Taxation of Corporations" [8] includes major proposals with respect to corporate acquisitions, liquidations and distributions. In fact, the Staff Report points out the desirability of consistency and simplicity with respect to the tax treatement of acquisitions, liquidations and distibutions. To ensure such consistency, Congressional action on the tax treatment of distributions should be deferred until the many complex, broader policy issues can be addressed.

At the October 24, 1983 Senate Finance Committee hearings on this Staff Report, Deputy Assistant Secretary of the Treasury Ronald Pearlman emphasized the complexity of these kinds of changes. He stated:

"We wish to emphasize that the scope of these proposals is enormous. They would make fundamental changes to the rules that govern the most basic, as well as the most intricate, corporate transactions, some of which have been in the law since 1918. The proposals would effect, to some degree, every corporation and every shareholder. Accordingly, we strongly believe that adoption of these proposals should come only after they have been translated into specific statutory provisions and subjected to deliberate and detailed technical and policy analyses by all interested parties."

Furthermore, the Senate Finance Committee staff, itself, recognized that imposing a tax on appreciation of property in these types of situations is a *drastic step.* Accordingly, the staff suggested a 12 year phase-in of this new tax with respect to "historic assets."

Sixth, there are a wide variety of reasons for the disposition of appreciated assets by a corporation. As examples, a corporation may be forced to dispose of business assets under pressure from regulatory authorities or lenders or a corporation may be forced to dispose of assets by virtue of high property taxes. If shareholders of a corporation can put these unwanted assets to productive use, present law provides for only a shareholder level tax upon the distribution of capital assets. Thus, imposition of a double tax interferes with good business practices.

V. CONGRESS MUST REJECT THE PROPOSAL TO REDUCE BY THE AMOUNT OF CERTAIN EXTRAORDINARY DIVIDENDS (TO THE EXTENT NOT SUBJECT TO TAX) THE BASIS OF CERTAIN STOCK HELD BY CORPORATE SHAREHOLDERS

As part of the Administration's Fiscal Year 1985 Revenue Proposals, the fair market value of extraordinary dividends (to the extent not subject to tax) would reduce the basis in stock held one year or less by a corporation.[9]

Enactment of this proposal will result in unnecessary multiple taxation, reduce stock market liquidity and aggravate the existing bias in the tax law in favor of debt and against equity financing.

The proposed basis reduction has the effect of arbitrarily adding another layer of income taxation to certain corporate transactions in which one corporation (the investing corporation) invests in the shares of stock of another corporation which happens to make certain distributions to shareholders (the distibuting corporation). *First,* the earnings of the distributing corporation are subject to the regular corporate income tax at rates which go as high as 46 percent under section 11(b) of the tax code. *Second,* in some instances, depending upon the characteristics of the distributing corporation, that distributing corporation will also be subject to the 15 percent "add-on" minimum tax under section 56 of the tax code.[10] *Third*, in many instances, dividends paid by the investing corporation to its own individual shareholders will be taxed to those individuals at rates as high as 50 percent pursuant to sections 61(a)(7) and 316 of the tax code. *Fourth*, the proposed basis reduction, in some instances, could add a substantial capital gains tax upon the disposition of the relevant stock by the investing corporation.

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[6] H.R. 4242, 97th Congress, Public Law 97-34.

[7] Report of the Committee on Finance, United States Senate, Economic Recovery Tax Act of 1981, Senate Report 97-144, page 25.

[8] *"The Reform and Simplication of the Income Taxation of Corporations,"* A Preliminary Report Prepared by the Staff, Committee on Finance, United States Senate, S. Prt. 98-95, September 22, 1983.

[9] "Revenue Proposals Contained In the Administration's Fiscal Year 1985 Budget," Department of the Treasury, Fact Sheets, February 1, 1984, item 23.

Multiple layers of tax are a clear impediment to capital formation. These tax burdens impede the free flow of capital and distort the pricing of capital assets. Accordingly, Congress should not adopt this corporate basis reduction proposal.

It is essential to point out that corporate investment in the stock market provides an important source of liquidity to ensure that our capital markets perform as efficiently as possible in allocating investment in our economy. Such investment provides important market discipline to avoid economic distortions. Thus, the basis redution proposal could reduce stock market liquidity.

Our tax law already has a distinct bias in favor of debt financing as compared to equity financing. To the extent that the proposal reduces equity investment, the proposal increases this bias. Under current tax law, the most important example of this bias is the fact that a corporation will obtain a deduction under section 163(a) of the tax code for interest paid on indebtedness whereas dividends paid on stock are not deductible.[11] Boris I. Bittker and James S. Eustice, two of the leading corporate income tax scholars, have stated that this bias in the tax code "may stimulate the excessive use of debt instead of equity investment in the corporate capital structure, thereby increasing fixed annual charges and helping to bring on insolvency, with consequent economic dislocation and losses both to the enterprise and the national economy."[12]

Thus, the proposed amendment to the tax code would tend to further encourage a highly leveraged capital structure which impairs the ability of corporations to withstand adverse economic developments.

VI. CONGRESS MUST REJECT THE PROPOSED RESTRICTIONS ON THE INTEREST PAID DEDUCTION AND DIVIDENDS RECEIVED DEDUCTION WITH RESPECT TO CERTAIN CORPORATE INDEBTEDNESS

As part of the Revenue Proposals in the Administration's Fiscal Year 1985 Budget, "where a corporate stock investment is directly attributable to a borrowing, interest deductions will be disallowed to the extent the dividends received deduction is claimed with respect to dividends on the stock."[13]

Under section 243 of the tax code, a corporate shareholder may generally deduct 85 percent of the dividends it receives. In addition, under section 163 of the tax code, interest paid or accrued on money borrowed by a corporation is generally fully deductible.

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[10] Under present law, corportions must pay a minimum tax on certain preferences. This tax is in addition to the corporation's regular tax. The amount of the minimum tax is 15 percent of the corporation's tax preferences in excess of the greater of the regular income tax paid or $10,000.

The tax preferences items included in the base of the minimum tax for corporations are: (1) accelerated depreciation on real property in excess of straight-line depreciation over the useful life or recovery period (in the case of property eligible for ACRS, 15 years); (2) amortization of certified pollution control facilities (the excess of 60-month amortization over depreciation otherwise allowable); (3) in the case of certain financial institutions, the excess of the bad debt deductions over the amount of the deduction computed on the basis of actual experience; (4) percentage depletion in excess of the adjusted basis of the property; and (5) 18/46 of the corporation's net capital gain.

In addition, the Tax Equity and Fiscal Responsibility Act of 1982 scaled back the following corporate tax preferences by 15 percent: percentage depletion for coal and iron ore; excess bad debt reserves of financial institutions; interest incurred by financial institutions to carry tax-exempt obligations acquired after 1982; DISC; section 1250 recapture on real estate; rapid amortization of pollution control facilities; intangible drilling cost of integrated oil companies (which are to be amortized over 36 months); and mining exploration and development costs (sec. 291).

[11] Payment of *debt* at maturity may constitute a "reasonable business need" under section 533(a) of the tax code which will justify an accumulation of earnings and profits and thus help to avoid the accumulated earnings penalty tax imposed by section 531 of the code; the redemption of *stock*, however, is less likely to qualify as a "reasonable need of the business." Payment of principal on *debt* will ordinarily be a tax-free recovery of basis to the creditor (or will produce capital gain under section 1232 if the collections exceed the adjusted basis of the debt); whereas the redemption of stock is often taxed as a divident to the redeemed shareholders.

[12] Federal Income Taxation of Corporations and Shareholders, Boris I. Bittker and James S. Eustice, 1979, page 4-3.

[13] "Revenue Proposals Contained in the Administration's Fiscal Year 1985 Budget," Department of the Treasury, Fact Sheets, February 1, 1984, item 23.

This proposal would reduce stock market liquidity and discourage equity financing. The proposal would make certain stock less attractive to corporate investors and thus increase financing costs for many corporations. The proposal is inconsistent with the action taken by Congress in recent years to encourage risk taking and increase equity investment by such measures as the reductions in the capital gains tax. The 1978 Revenue Act increased the capital gains exclusion for individuals from 50 to 60 percent. The 1978 Revenue Act also reduced the corporate alternative tax rate on capital gains from 30 to 28 percent.[14] With respect to these changes, the Report of the Senate Finance Committee for the 1978 Revenue Act stated that "the improved mobility of capital and the increased after-tax profitability of potential investments will lead to a substantial increase in investment activity."[15] In 1981, Congress took further steps which would help promote equity investment by reducing the maximum income tax rate on individuals from 70 to 50 percent.

VII. CONCLUSION

In summary, tax proposals that impede the creation of oil and gas royalty trusts will reduce market efficiency. There is simply no justification in terms of U.S. economic or energy policy for the adoption of such restrictions. Oil and gas royalty trusts can improve business productivity and provide for the most efficient allocation of capital in our economy. This will also help maximize the efficiency of the U.S. energy industry. Furthermore, the creation of oil and gas royalty trusts will increase federal tax revenues.

Royalty trusts may achieve similar objectives in such industries as timber and mining.

STATEMENT OF CHERYL MOSBY, IDAHO FALLS, IDAHO

I am a Revenue Agent with the IRS and have been examining tax returns, including many with tax shelters for over nine years.

Tax shelters have become an increasing enforcement problem to the IRS. Their use has also added to the public perception that our system isn't equitable and that many people are getting away without paying their fair share. This problem is caused by both the abusive tax shelters which tie up our examination time, and the so-called legitimate shelters which have been enacted to serve various social purposes.

My suggestion is to eliminate the potential for almost all tax shelters by limiting allowable deductions from any activity to the income from that activity and also limiting credits to the tax generated by the activity (much as was done with the early New Jobs Credit rules). Then, to be fair to the legitimate businesses that generate losses occasionally, allow carrybacks and carryovers again within those limits.

If this were done, we would no longer need the complicated and subjective rules of Sections 183 and 465.

I realize that certain laws, like the exclusion of rental properties from the 465 at risk rules, were done to serve a social purpose. However, the harm they do by allowing tax benefits to some and not others, exceeds the benefit. In fact we ought to reconsider whether it is appropriate to use the tax law to influence the social and economic activities of people.

You may think that all we have to do is increase the penalties and tighten up Section 465. Then the IRS will have all of the tools necessary to eliminate the abusive shelters. But it doesn't work that way. Every time rules are tightened, there are people who will try to get around them. It is true that we can usually refute the schemes, but that takes a lot of examination time to read all the documents and study the law. The IRS is made up of people. We don't always think with one mind or know what is going on everywhere. The tax law is so complicated that we can't know it all.

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[14] Under section 1201 of the tax code, a corporation cannot take advantage of the special 60 percent capital gains exclusion. Instead a corporation computes its tax in the following manner: The excess of net long-term capital gain over net short-term capital loss is included in income and a tax at the regular corporate tax rates is computed. Then an alternative tax is determined by: (1) Computing a tax at the regular tax rates on the corporation's taxable income minus the excess of net long-term capital gain over net short-term capital loss, and (2) adding to this the alternative capital gain tax computed by multiplying the excess net long-term capital gain by 28 percent. The method producing the lower result is used.

A corporation, like an individual, offsets its capital losses against its capital gains. But if it has an over-all capital loss, the corporation, unlike an individual, may not offset it against ordinary income to any extent. Instead, the corporation's excess capital loss is subject to the carryover and carryback provisions.

[15] "Revenue Act of 1978," Report of the Committee on Finance, United States Senate, S. Rept. 95-1263, page 15.

We have been devoting so much time to the examination of shelters that the regular DIF audit program has suffered. Many people who would have been audited in the past with good results have not been. They may be beginning to feel that as long as they stay away from shelters they will be safe to do what they want.

I urge you to consider my suggestion. If you think it is too broad or drastic, add it to the tax preference items for minimum tax. We are to the point where tinkering with the current laws will no longer work. The last thing we need is more rules. What we need is to uncomplicate the law by making a clear and easily enforced rule.

PROPOSED NEW CODE SECTION ELIMINATING 183 AND 465

Expenses and other deductible items from any activity shall be allowed as deductions only to the extent of income from that activity. Each separate activity, as defined by regulations, shall be shown on a separate schedule.

The sections dealing with investment credit and net operating losses should also be modified to reflect these changes.

Any losses claimed on returns can then be adjusted by the Service Centers as mathematical changes not even requiring examinations. The current penalties for negligence and fraud can be used to enforce the separate schedule rules. Many of the newly enacted penalties against tax shelters can then be eliminated.

STATEMENT OF PETER H. BELL, EXECUTIVE DIRECTOR, NATIONAL HOUSING REHABILITATION ASSOCIATION

The National Housing Rehabilitation Association is an organization comprised of companies active in the business of rehabilitating housing for low and moderate income families. Members of the association include developers, builders, and legal and financial professionals. They include some of the most active participants in the multifamily housing field, and account for a significant proportion of the rental units which have been rehabilitated throughout the country.

Section 167(k) of the Internal Revenue Code, which expired on January 1, 1984, authorized a five-year write-off of expenditures incurred in the rehabilitation of housing for lower income families. The provision has proven to be an important and effective tool in stimulating the preservation of affordable housing in inner city neighborhoods. Bills to extend 167(k) have been introduced by Senator Moynihan and Congressman Rangel (S. 2089; H.R. 4227). The National Housing Rehabilitation Association strongly urges that the bills be enacted.

While 167(k) has in the past been used in conjunction with housing production subsidy programs such as Section 8, it is increasingly being used by nonprofit low-income housing organizations. Nonprofit sponsors of housing rehab projects have been using 167(k) to raise equity capital and to cover operating cost deficits. Many projects have used the syndication proceeds to subsidize rents at levels affordable to low income households.

With the diminution of federal housing assistance programs, it is important to retain 167(k) to entice the private sector to be involved in the revitalization of inner city housing. Furthermore, 167(k) may prove to be crucial to the success of local efforts to preserve rental housing and to provide shelter for lower income families.

Attached is a background report on 167(k) prepared by the National Housing Rehabilitation Association. Included in the report is a description of how a number of entities are utilizing 167(k) in the absence of any direct federal housing subsidies.

The National Housing Rehabilitation Association urges the House Ways and Means Committee to adopt the bills extending 167(k).

SECTION 167(k): A DESCRIPTIVE SUMMARY, BY DAVID SINGER, RESEARCH ASSOCIATE AND PETER BELL, EXECUTIVE DIRECTOR, NATIONAL HOUSING REHABILITATION ASSOCIATION

Section 167(k) of the Internal Revenue Code, first enacted as part of the Tax Reform Act of 1969, permits owners of rental housing units reserved for occupancy by lower income families to write-off costs incurred for rehabilitation as depreciation deductions on an accelerated sixty month schedule. The statute expired on Jan.

1, 1984 after previously being extended in 1976, 1977, and 1980. Bills to extend the provision through 1994 have been introduced by Senator Daniel Moynihan (S. 2089) and Congressman Charles Rangel (H.R. 4227).

In 1969 Congress recognized the need to provide some suitable incentive for the rehabilitation of substandard rental units. The tax incentive was viewed as an effective means of stimulating rehab on the large stock of dilapidated buildings in innercity neighborhoods. In both House and Senate reports accompanying the 1969 Tax Reform Act, Congress clearly expressed its intent to have 167(k) make it attractive for builders and developers to take on the "uneconomical" job of revitalizing innercity low income housing. It was further intended that the provision serve to help stimulate creation of a strong rehabilitation industry.

Prior to 1969, there was neither an extensive nor an effective rehabilitation industry in the United States. Private entrepreneurs were reluctant to become involved in multifamily rehab because it was viewed as unprofitable. Nonprofit developers lacked the technical sophistication and financial resources required for this inherently risky business.

In major rehabilitation, it is often difficult to estimate replacement needs until a property has been acquired and "gutting" commenced. It is frequently impossible to assess what is behind the walls or the overall condition of plumbing, wiring, and structural components until substantial investment has been committed. Furthermore, properties with rehab potential tend to be located in marginal neighborhoods with their attendant problems of blight, vandalism, and crime. As a result, significant amounts of up-front expenditures, far greater than those required for suburban new construction, must be made before a rehab project can go forward.

By enacting 167(k) in 1969, Congress invited developers and investors to take on the challenges and risks of major housing rehabilitation in the inner cities. The vehicle offered to entice their participation was a dramatic five-year write-off of rehabilitation expenditures.

In the years since 1969, 167(k) has fueled development of an effective rehabilitation industry, with active participation by both private developers and community-based not-for-profit groups. Both types of participants have been able to attract necessary equity capital from outside investors only because of the availability of 167(k).

ADVANTAGES

Aside from the "pump-priming" role 167(k) plays in helping project sponsors attract equity investment, the provision offers strong mechanisms for insuring that projects will be completed, manageable, and economically viable; that they will not quickly deteriorate into slum properties once the tax incentives are gone. The severe recapture provisions of the tax code force investors and developers to take a continuing interest in the success of their projects.

This occurs in two ways. First, the tax benefit is linked to the project's financial success. The tax subsidy is given each year in the form of losses as the product (a financially successful rehabilitated apartment project) is delivered. Second, if a project is foreclosed, the investors will be faced with recapture of the previously claimed tax benefits, as well as the loss of their original investment.

The recapture threat serves as an important incentive for keeping the project in good repair so that it is attractive to the tenants. It ties the investors interests directly to the overall financial and physical health of the property, and provides strong encouragement for recipients of the tax benefit (investors) to screen projects carefully before investing.

The passive investors also provide a potential source of reserve funds if a project runs into operating difficulties over the course of its life (16 years, 9 months to avoid recapture). Although limited partners are generally not required to provide funds beyond their initial investment, if it is clear to them that an infusion of additional funds would avoid the much greater costs of foreclosure and recapture, they are apt to provide the necessary financial resources.

This availability of additional private funding sources to cover unanticipated operating deficits could well mean the difference between a rehabilitated housing project which continues to contribute to the aesthetic and social improvement of its neighborhood, and one which returns to its original dilapidated condition.

STATUTORY REQUIREMENTS

In order to depreciate rehabilitation expenses over a five year period under Section 167(k), a taxpayer must make qualified rehabilitation expenditures of between $3,000 and $20,000 per unit over a period of no longer than two consecutive years.

Amounts in excess of $20,000 per unit must be treated under other depreciation methods. The minimum and maximum levels were intended to insure that the rehabilitation would involve substantially more than minor redecorating costs, while at the same time preclude the use of the tax benefit for luxury-type improvements.

A special $40,000 per unit depreciation allowance under 167(k) was included in the Economic Recovery Tax Act of 1981. The ceiling is raised for programs providing homeownership opportunities for tenants. The program must be certified by HUD or a state or local government agency, and the program must require the taxpayer to certify the amount of rehab expenditures to the appropriate authority. In addition, there must be a reasonable expectation that the sum of the taxable income from the rental of the unit and the amount realized on its sale or disposition will not exceed the seller's adjusted basis in the unit (determined without adjustment for depreciation) reduced by the net tax benefit realized from the rental of the unit. The net tax benefit is the amount by which the taxpayer's income taxes are reduced by depreciation deductions, minus the taxes attributable to net rental income on the unit (the excess of income over deductions other than depreciation).

Once the rehabilitation is completed, the units for which the rapid write-off has been claimed must be reserved for occupancy by lower income families. The definition of lower income has been consistent with the definition used in HUD progams: 80 percent of median income for the market area. The statute also requires income certifications of the taxpayer's tenants to be filed with the election to use 167(k). If a unit fails to meet all of the statutory requirements for 167(k) treatment, the taxpayer's election for that unit is revoked.

APPLICATIONS OF USE

The use of 167(k) as a development enticement and a management incentive corresponds with the philosophy behind the new Rental Rehab and Multifamily Development Grant programs enacted by Congress in December 1983. The new programs place great emphasis on creating the most number of units with the least amount of HUD funds. For the programs to successfully stimulate rehabilitation in urban neighborhoods, 167(k) must continue to be made available so that owners can afford to make necessary property improvements and still charge rents at the mandated low-income levels.

Historically, 167(k) has been used in conjunction with section 8 and other federal housing assistance programs. There is, however, no such requirement in the statute or regulations; nor was such a requirement envisioned by Congress when it was initialy enacted.

The Urban Institute, in a draft report commissioned by HUD, essentially concluded that 167(k) was no longer a viable incentive absent section 8. Yet the provision is increasingly being used in projects receiving limited local assistance or no other subsidy at all. It is commonly used in conjunction with projects developed by not-for-profit sponsors who use the provision to raise funds for equity and operating reserves. Alternatively, 167(k) provides a method whereby community self-help organizations attract private firms to work with them on joint ventures, allowing the community organizations to tap the technical expertise they need to house and employ their constituents.

As local governments take an increased responsibility for the delivery of housing to serve the needs of their lower income populations, they will need to have available the same tax incentive tools that have been available during the years of large volume federally assisted production. To deny them the use of tools that have proven effective for attracting equity investment to low income housing will hamstring their efforts from the start. They cannot be given the responsibility without the tools and be expected to carry out the task. Section 167(k) is a tool of enormous value for municipalities to use in convincing property owners that it is worth their while to upgrade and maintain rental housing, rather than to demolish it and sell the land, or convert it to condominiums for higher income clientiele.

Furthermore, in 1983 HUD reported to Congress that most of the benefits of tax incentives for rental housing are passed through to the tenants in the form of lower rents. In analyzing the impact of tax incentives for rental housing, the report concluded that, in the long run, the incentive attracts more investment and leads to lower rents. ("Federal Tax Incentives and Rental Housing" HUD PDR-731, 1983).

EXAMPLES OF CURRENT USE

Senator Dan Quayle of Indiana sponsored the amendment to 167(k) in 1981 which changed the per unit rehab expenditure limit from $20,000 to $40,000 for programs providing for homeownership opportunities for lower income households. The change was initiated in resonse to a program undertaken by an insurance company in Fort Wayne, Indiana. Senator Quayle described the program on the floor of the Senate:

An insurance company which is headquartered in Fort Wayne has been buying abandoned, or otherwise unsuitable housing and spending the amount of money necessary to make those structures habitable. In conjunction with several banks, the insurance company has been taking half of the amount they have invested and getting a 15 year mortgage for that amount.

It is the insurance company's position that the other half—the half not mortgaged—is a donation to the community. It is a corporate contribution to Fort Wayne.

The insurance company, having renovated a single family dwelling, then rents that house to a low income tenant for only the amount necessary to cover the mortgage, taxes, insurance, and a small reserve for repairs.

The city of Fort Wayne, as its part in the program, has been fixing the streets, curbs, and lighting.

After 5 years, if the tenant has lived up to the terms of the lease, the insurance company sells the house to the tenant for $1. The bank transfers the remaining 10 years of the mortgage to the new owner, thereby completing the cycle.

Mr. President, this program does more than rehabilitate dwellings; it creates homes. It does more than improve the tax base; it creates neighborhoods.

We have worked this (amendment) out to take care of a particular situation in my state . . . where some of the companies have been involved in rehabilitating low-income housing. They have done this in a unique way. They have bought property for virtually $1. They have rehabilitated the property and assumed the mortgage for one-half the amount of the project.

What they have done is unique, and it is hoped that we can get other corporations and foundations to take an interest in this type of project particularly as we have increased the exemption [sic] from $20,000 to $40,000—to take a keen interest in rehabilitating low-income housing in the cities.—127 Cong. Rec. S8326-27 (daily ed. July 24, 1981) (statement of Sen. Quayle).

Senator Quayle's amendment received the backing of both Senator Robert Dole and Senator Russell Long of the Senate Finance Committee. Senator Long stated that 167(k) was working well and deserved to be tried on a broader basis.

What follows is a description of how a number of entities are using 167(k) to help create rehabilitated housing units for low-income tenants and homeowners. This is occurring without direct federal housing subsidies such as Section 8.

THE REHAB PROJECT, LIMA, OHIO

Rehab project is a private, nonprofit corporation established in 1977 by local churches to stimulate neighborhood revitalization through housing rehabilitation and homeownership activities. Through its homeownership Program, the Rehab Project has facilitated the renovation of over 120 houses in the Lima community, representing over $1,100,000 in property reinvestments. In the context of its Homeownership Program, Rehab Project devised a tax syndication program whereby Rehab Project forms a limited partnership with investors, who are enticed into participating due to the availability of 167(k). The house is leased to a low-income client, and a portion of the rent the tenant pays is escrowed to raise money for the eventual purchase of the home by the tenant. This program functions without direct federal housing subsidies. The program's intent of fostering low and moderate income homeownership moderates the profitability to the private investor (e.g. 11-12% after taxes for a person in the 50% bracket).

HOUSING DEVELOPMENT CORPORATION OF LANCASTER COUNTY, PA.

In the last several years, the Housing Development Corporation of Lancaster County (HDC) has developed over 1,250 units of housing that serve low and moderate income families. HDC's rehab efforts employ a variety of resources to finance the work. 167(k) has been an integral part of attracting investor funds to subsidize rentals for low-income tenants. HDC's plan to develop rehabilitated housing allows them to leverage CDBG funds together with equity capital raised from investors to subsidize rents for low income tenants. Investor contributions are utilized to offset cash flow deficits during the early years of the project operation.

According to projections made by HDC, the loss of 167(k) will reduce investor funding by approximately 25%. Consequently, HDC will be forced to use more CDBG funds—possibly as much as 50% more per unit—thus reducing the number of units rehabilitated. HDC currently has in its pipeline four projects consisting of 110 units, all of which had contemplated using 167(k) to attract investor capital.

THE FINCH GROUP

The Finch Group, based in Boston, Massachusetts, works with distressed subsidized housing by working out mortgage modification and reinstatement programs. The following list of Finch projects all utilize 167(k) to raise equity in order to subsidize the operating costs of the buildings:

Centerville Court Residential Project, North Syracuse, N.Y. consists of 152 units of elderly housing financed with a mortgage from the New York State Urban Development Corporation.

Princeton Village Apts., Lowell, MA is a project consisting of 151 units of low-income family housing. Financing was provided with a $2,225,700 mortgage issued under FHA's 221(d)(3) program.

Dudley Park Apts., Albany, N.Y. is 263 units of low-income family housing financed with a $4,750,000 mortgage issued under 221(d)(3).

Douglas Harrison House, Newark, N.J. consists of 754 units financed with a $8,500,000 conventional purchase money mortgage, plus additional funding from the New Jersey Housing Finance Agency.

Northern Canal Apts., Lowell, MA consists of 263 units financed with a $4,065,000 mortgage issued under 221(d)(3).

Woodland Village, Providence, RI consists of 263 units using $4,289,700 HUD BMIR.

The Finch group contends that without the use of 167(k), their work on distressed subsidized housing would be severely impacted.

CENTER CITY HOUSING, MISHAWAKA, INDIANA

The 100 Center Development Company is working on a project consisting of 70 units of elderly and family housing. The developer is financing the project with a mortgage issued under FHA's 223(f) program. 167(k) is slated to be used to raise equity so as to subsidize operating expenses and the low income rentals.

COMMITTEE FOR THE HEIGHTS-INWOOD HOMELESS, NEW YORK, N.Y.

This nonprofit group was created to facilitate efforts to house the homeless in upper Manhattan. The group received a $300,000 grant from the State of New York; a $250,000 loan was obtained from New York City Participation Loan Program; $250,000 in conventional mortgage financing; $200,000 through selling equity via 167(k). The syndication proceeds are to be used to pay the builder, who is part of the development team, for his out-of-pocket costs. The remainder will be divided between the nonprofit sponsor and the developer. Other social service costs of the project will be paid for with various public and private foundation grants.

SYNDICATION OF A LOW INCOME CO-OP IN BROOKLYN, N.Y.

The Community Development Legal Assistance Center of New York developed a financial plan whereby tenants bought a run down building from the owner. The plan to save and rehab the building involved six different sources of funding. New York City provided construction financing, committing $825,000 through its Participation Loan Program at 1% interest. Citibank offered conventional mortgage financing of $775,000. To raise the equity necessary to obtain the loans, the tenants transferred title to the property to a limited partnership and syndicated ownership shares to a small group of limited partner investors. The syndication raised $250,000 in cash for the project as a result of 167(k). When the rehab work is completed this spring, the property will be eligible for J-51 tax abatement, thereby reducing operating costs further.

The tenants have the option to repurchase the building between 5 and 15 years after construction is competed at a price of $1,000 per unit, plus assumption of the existing mortgage. The final source of funds will come from the creation of a leasehold cooperative whereby the tenants purchase their individual shares at an average price of $700. These funds will be set aside in an interest bearing account earmarked for the building's eventual repurchase by the tenants.

MANNA, INC., WASHINGTON, D.C.

Created in 1982, MANNA, Inc. is a nonprofit organization dedicated to combating neighborhood deterioration in the Washington, D.C. metropolitan area. MANNA acquires, rennovates, and makes available to lower income families, vacant single family and multifamily housing units. The housing is acquired from the District's city-owned stock as well as through foreclosure sales. Below market financing has been provided by OPEN, a nonprofit mortgage company, and conventional financing has been obtained from local savings and loan institutions.

MANNA devised a shared equity program which enables lower income families to become homeowners. A family, typically cash poor with a modest but reliable income, joins with a private investor, and the two purchase the property, acquired by MANNA, as tenants-in-common. The investor makes the downpayment and owns a percentage of the property, usually 90 or 95%. He is thus able to use the tax benefits associated with holding investment property. The occupant enjoys the benefits of homeownership. The occupant and investor jointly borrow a first mortgage loan and pay proportionagely on the note. In addition, the occupant pays the investor a pro rata share of rent. The occupant's monthly housing cost is reduced during the first five years as a result of a property tax waiver provision in the District of Columbia. The occupants negotiate Shared Equity Agreements with their invetor partners which specify "buy out" prices and schedules. Typically, the occupant has an option to purchase the investor's share and be an owner in fee simple in the sixth year.

MANNA's program does not rely upon any deep subsidy program. It relies instead on private market and philanthropic activities augmented by the District's real estate tax waiver for eligible first time homebuyers. 167(k) is needed to attract private investors to this program and to facilitate the necessary rehabilitation work.

CONCLUSION

Section 167(k) has proven to be an effective incentive for encouraging the preservation of rental housing affordable to lower income families. With rental housing production down and housing for homeownership being built only for higher income households, it is crucial to the success of local efforts to preserve rental housing and to provide units for lower income populations that 167(k) be renewed.

NEWHALL INVESTMENT PROPERTIES,
Valencia, Calif., February 27, 1984.

Mr. JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR SIR: Newhall Investment Properties is a publicly traded limited partnership, listed on the New York Stock Exchange, with approximately 3,000 partners. We have reviewed your "Proposals Relating to Tax Shelter and Other Tax-Motivated Transactions," dated February 17, 1984, and disagree with your proposal relating to publicly traded partnerships.

Publicly traded partnerships have been formed through spin-offs from publicly traded corporations such as Timber Realization and Ala Moana. Others have been formed through the combination of numerous non-traded partnerships, so-called roll-up transactions. An example of this form is the Apache Company. In both of these instances, there is no tax abuse involved.

In our particular case, Newhall Investment Properties was spun-off from The Newhall Land and Farming Company. Newhall Investment Properties distributes taxable income, not losses, to its partners.

Your proposal to treat partnerships which are publicly traded and/or consist of more than 100 partners as corporations fails to consider any aspect other than the number of partners. We feel that this is very short-sighted and does not look at the overall picture.

Sincerely,

ROBERT D. WILKE, *General Partner.*

NEWHALL LAND & FARMING CO.,
Valencia, Calif., February 27, 1984.

Mr. JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR SIR: While not agreeing with many of the conclusions and proposals within "Proposals Relating to Tax Shelter and Other Tax-Motivated Transactions," dated

February 17, 1984, in particular I wish to object to the proposals relating to publicly traded limited partnerships found on page 30 of the report.

Current law recognizes the corporation as a separate legal entity, while a partnership is viewed as an aggregation of partners. Several non-tax related characteristics arise from this distinction. Your proposal to treat partnerships which are publicly traded and/or consist of more than 100 partners as corporations fails to consider these distinctions. Current law clearly defines the true characteristics of a partnership; this proposal gives decisive importance to a single classification characteristic which neither affects the operation, nor structure of the entity.

The Internal Revenue Code provides special treatment, as opposed to that for a corporation, for a number of entities which are publicly traded and are tax free at the entity level. If our tax system is to be neutral and impartial, why have partnerships been singled out?

Many publicly traded partnerships have been formed thorugh the combination of numerous untraded partnerships, so-called "roll-up" transactions. There is obviously no tax abuse involved in a roll-up, since the partnership form is maintained before and after the transaction. These transactions have provided liquidity to partners who could not otherwise readily dispose of their partnership interests, additionally subjecting the partners to tax on the disposition on their units and consequently increasing the treasury's coffers.

Lastly, I failed to find the converse of your proposal to tax partnerships as corporations, that is the proposal to treat non-publicly traded corporations with fewer than 100 shareholders as partnerships.

Sincerely,

DAVID L. LINDEN, *Secretary-Treasurer.*

STATEMENT OF LEON M. NAD, NATIONAL DIRECTOR OF TECHNICAL TAX SERVICE, PRICE WATERHOUSE

SUMMARY

Existing tax laws and regulations provide a proven standard for determining the Federal income tax classification of an entity as a partnership or a corporation. These standards focus on each of the fundamental structural differences between such entities. we believe the proposal initially introduced in the Preliminary Report of the Staff of the Senate Committee on Finance, S. Rpt. 98-95, 98th Cong. 1st Sess., ("Staff Report") and included as a proposal associated with other "Proposals Relating to Tax Shelters and other Tax-Motivated Transactions" by the Staff of the Joint Committee on taxation dated February 17, 1984 ("Joint Committee Report") does not recognize these fundamental differences. We believe the recommendation to utilize free transferability alone is not an adequate or fair basis for distinguishing limited partnerships from corporations. The proposal that arbitrarily limits the number of partners in a partnership to 100 members (the "Pease" proposals) similarly ignores the fundamental differences.

Further, it is our view, based on our experience as tax accountants for a broad segment of American business, that publicly traded limited partnerships can be properly audited and accounted for and, therefore, concerns regarding this matter are overstated. Finally, we are not aware of a significant move to disincorporate American businesses.

FUNDAMENTAL DISTINCTIONS BETWEEN PARTNERSHIPS AND CORPORATIONS EXISTING STANDARDS

Generally, state laws recognize the corporation as a separate legal entity while a general partnership is viewed as an aggregation of partners. Several non-tax characteristics arise from this fundamental distinction:

(1) A partner is liable for the debts of the partnership while the shareholder of a corporation has no personal liability for its debts.

(2) A partnership's life is limited while a corporation continues indefinitely.

(3) Management vests with some or all the partners of a partnership while management of a corporation is delegated by the shareholders to its officers.

(4) The transfer of a partnership interest by a partner may be limited or restricted whereas, in principle, corporate stock is generally freely transferable.

Limited partnerships have characteristics which lie between those of corporation and general partnerships. Ordinarily, a limited partnership formed under the Uniform Limited Partnership Act, or the various state equivalents, possesses sufficient characteristics to be defined as a partnership, not as an association taxable as a corporation.

The Income Tax Regulations and case law have developed standards for distinguishing limited partnerships from corporations. These standards focus on the four fundamental differences previously discussed.

PROPOSALS IN THE JOINT COMMITTEE REPORT

The Joint Committee Report's proposals would replace current standards, in effect for more than twenty years, for distinguishing partnerships from corporations. The "publicly-traded" proposal would place one characteristic; i.e., free transferability of interest, in a position superior to all others. Possession of that characteristic alone would automatically cause an entity to be treated as an association taxable as a corporation with no recognition of the other fundamentl distinctions between a partnership and a corporation. The Pease proposal would arbitrarily distinguish partnerships from corporations simply because of the number of partners required to form an economic unit for its intended purpose regardless of all of the traditional tax law and business distinctions. We believe that adoption of either of these approaches is unwarranted as a matter of sound tax policy.

FREE TRANSFERABILITY SHOULD NOT BE THE KEY STANDARD

Free transferability alone should not be the linchpin for distinguishing limited partnerships from corporations because it is not the exclusive characteristic of either type of entity.

The premise of the Staff Report was that all corporations are characterized by free transferability while limited partnerships are not. In reality, most corporations do not possess this characteristic. There is little or no market, apart from current owners and their families, for the stock of closely held corporations. In addition, many corporate shareholders are subject to buy-sell agreements precluding free transferability of their shares.

Although many limited partnership agreements provide that permission of the general partner must be obtained prior to a transfer, in the vast majority of such cases such permission is freely granted and partnership units are transferred. The recent movement to publicly traded limited partnerships simply institutionalizes and makes more convenient a practice that already exists.

A "HEADCOUNT" SHOULD NOT BE THE KEY STANDARD

The Pease proposal provides that if more than 100 business entities or individuals join together with a common business purpose, the resulting entity should be taxed as a corporation. To make a "headcount" the sole determining characteristic of tax classification ignores both the economic reality and legal distinctions. As discussed below, there are fundamental differences between such entities. The main reason that some partnerships require more than 100 members is simply to raise the requisite capital for their intended purpose. Additionally, many service entities (e.g., law and accounting firms) have more than 100 partners to properly service their clientele.

REASONS TO CONSIDER OTHER FUNDAMENTAL DIFFERENCES

To tax limited partnerships as corporations would ignore other basic differences between partnerships and corporations that regulatory agencies, taxing authorities, and the business community have long recognized.

Corporations have long been subject to franchise, business license, capital stock, and other state taxes because they are legally different from partnerships. Corporations and partnerships are generally subject to substantially different federal and state regulatory and securities-law rules.

Over the years, income tax law has strongly emphasized the "aggregate" rather than the "entity" approach. For example, upon a partner's sale or transfer of his interest in a partnership, the character of any resultant gain as reflects the nature of the underlying assets of many partnerships (e.g., inventory, unrealized receivables) in which the partner is considered to have an interest. In contrast, corporate shareholders generally realize capital gain or loss on sale of their stock.

Because of the fundamental features of the corporate form, only certain activities are generally conducted as partnerships. Operations such as real estate investments and oil and gas exploration and development have been conducted as partnerships because of the pass-through of tax benefits, the limited duration of the business organization and the need for the individual partners to look through to effective ownership of underlying assets. Enterprises conducting manufacturing and distribution ordinarily have not been formed as partnerships because such enterprises generally require corporate characteristics (e.g., limited liability, indefinite life, centralized management).

"PASS-THROUGH" ENTITIES

The income tax law sanctions "pass-through" entities as long as certain criteria, specified in the statute and regulations, are satisfied. Currently, real estate investment trusts, regulated investment companies, trusts, estates and S corporations as well as partnerships are recognized and widely utilized. The Joint Committee Report proposes to eliminate certain "pass-through" entities by narrowing the definition of entities that would qualify as partnerships. This proposal, we believe, runs directly counter to the general trend Congress has followed in recent years.

"DISINCORPORATION" OF AMERICA

Existing publicly traded partnerships have generally resulted from two types of business restructuring:

"Rollups": Partners in several existing partnerships, and/or taxpayers holding interests individually, exchange their interests for interests in a newly created large partnership.

Corporate liquidation or spinoff: An existing corporation either spins off, or partially or completely liquidates, distributing the properties to its shareholders who subsequently contribute the business to a newly formed partnership.

In a "rollup", no corporate entities or related tax liabilities are eliminated. (The corporate liquidation or spinoff is encountered only rarely, in our experience).

There has been discussion regarding the potential "disincorporation" of America. (See *Forbes,* August 1, 1983, pp. 76–78). Although some businesses may have considered "rollups" and "disincorporation", we have not seen many such restructurings and have concluded that the following are the major reasons therefor:

Tax costs: There may be substantial initial tax liabilities incurred by shareholders or partners involved.

Administrative costs: There are high administrative costs of starting and operating as a publicly traded limited partnership.

State tax implications: A partner in a multistate partnership has extensive reporting requirements in various states whereas a shareholder in a multistate corporation generally does not.

FIRPTA Reporting: The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) established taxation and reporting requirements for foreign entities investing in U.S. real property. Nonresident alien partners in U.S. partnerships investing in real property (such as real estate and oil and gas partnerships) will be subject to FIRPTA reporting requirements.

From our firm's vantage point, it does not appear that corporate America is surging ahead to disincorporate.

ACCOUNTING, REPORTING, AND AUDITING

Accounting

The business community and the accounting profession have recognized and resolved a multitude of issues involved in properly accounting for partnerships, both large and small, public and private.

With respect to administration, publicly traded limited partnerships combine the concepts utilized in the existing partnership accounting and corporate transfer agents systems to account for the partnerships as required by various reporting constituencies; i.e., partners, the Securities and Exchange Commission, the Internal Revenue Service, other regulatory agencies, etc.

As an example, our client, The Newhall Land & Farming Company (Newhall) has developed a complete computer based system to account properly for its newly created publicly traded limited partnerships, Newhall Investment Properties and Newhall Resources.

Recognizing the aggregate concept of the partnership structure, the system treats each partner as an owner of his pro rata share of all partnership assets and liabilities and appropriately allocates to each his share of income, loss, credits, etc. In addition, the system has been designed to account properly for complex tax computations, including partial sales or additional investments by an existing partner, a "step-up" in tax basis to fair market value of a purchasing partner's interest, and many other transactions.

The above was described not only because we are intimately familiar with Newhall's system, but because one of its two partnerships is involved in oil and gas exploration and production. Accounting for such a partnership is complex because of the emphasis on the pass-through and determination at the partner level of certain items and the tax preferences associated with oil and gas taxation. Other partnerships have also developed similar computer-based systems. Thus, it has been demonstrated that sophisticated computer based accounting systems can accurately account for publicly traded limited partnerships.

Concern has been expressed about the difficulty caused by trading units in such a manner. It is well established that, although a large percentage of corporate stock is now in street name, the brokerage industry has been able to identify the beneficial owners. Similarly, publicly traded partnerships are confident that they can identify and properly report partnership information to partners owning units in street name. Several publicly traded partnerships have developed innovative systems that deal with this issue. A task force of representatives of publicly traded partnerships has been formed to work with the National Association of Securities Dealers to develop alternative methods of handling this problem. Although there may be some bookkeeping inefficiencies, the problems are not insurmountable.

Reporting

Reporting tax information to partners of publicly traded partnerships should not be a problem. Price Waterhouse and others have been reporting for both large and small partnerships for tax purposes for many years. While, conceptually, reporting for a partnership consisting of three partners should be the same as reporting for a partnership consisting of thousands, there are added complexities concerned with the latter. However, problems resulting from such complexities have been resolved.

Price Waterhouse has developed a computer based system for processing tax information for large limited partnerships in the oil and gas industry. One office alone processed 155,000 1982 Schedules K-1 for Form 1065. PTRS is capable of handling the most sophisticated tax computations. It has successfully faced the scrutiny of the IRS on many occasions. PTRS is interfacing with Newhall's accounting system to report accurately and properly all the required information to each partner in a timely fashion. This will be no different than the reporting done in past years, albeit for a higher number of transfers during the year because of the New York Stock Exchange listing.

It has been our experience that large limited partnerships provide accurate and timley information because of SEC reporting rules, required audited financial statements, and the information needs of the partners. Systems have been developed and are in place to report accurately and properly all types of partnership transactions.

IRS audit

Concern has been expressed that an IRS audit of a publicly traded limited partnership is difficult if not impossible. This suggestion ignores legislation enacted by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). With the objective of easing the administrative burdens previously placed on the IRS, TEFRA significantly changed the statutory procedures for auditing partnerships. The partnership audit now occurs at the partnership level in a unified proceeding rather than in separate proceedings with the partners.

In addition, each partner must treat each partnership item in a manner consistent with the treatment on the partnership return. Otherwise, disclosure on the partner's own return is required. Furthermore, TEFRA provides rules for centralizing communication with partnerships having more than 100 partners by requiring the designation of a "tax matters partner" and, under certain circumstances, a "notice partner". Centralization of settlement and litigation procedures has also been addressed in TEFRA. These changes should allow IRS to deal effectively with publicly traded partnerships.

PROFIT SHARING COUNCIL OF AMERICA,
Chicago, Ill., February 27, 1984.

JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR SIR: The Profit Sharing Council of America wishes to file a statement with the Committee in accordance with Press Release #19. The Profit Sharing Council is a non-profit association of approximately 1,300 employers who maintain profit sharing plans. These plans cover approximately 1,750,000 employees. Council members are located throughout the United States and are engaged in practically all areas of economic activity. Member companies range in size from Fortune 500 size companies down to very small businesses.

The Council is concerned with item F8 in the paper prepared by the staff of the Joint Committee on Taxation dealing with "Proposals Relating to Tax Shelters and Other Tax Motivated Transactions." Under item F8, an in-service withdrawal of non-deductible employee contributions from a qualified profit sharing plan would be treated as coming first out of earnings on the contributions, and lastly out of the non-deductible employee contributions. In addition, a 10% penalty tax would be imposed on any taxable income included in a withdrawal if it was not made on account of separation from service, death or disability, or after age 59½.

For many years, profit sharing plans have been encouraging employees to voluntarily contribute non-deductible contributions to plans, and millions of rank-and-file employees have done so. Our last survey of Council members disclosed that approximately 62% of our members' plans permitted or required such contributions. We estimate that at the present time there are well over $10 billion in employee contributions in profit sharing plans.

To encourage employees to make contributions, profit sharing plans allow liberal withdrawal privileges of employees' voluntary after-tax contributions. Employees have a number of motivations for making these contributions—savings to enhance their retirement security; to help purchase a home; for children's educational expenses; or to save for financial emergencies. Because these savings are made through payroll deduction, they have become very popular with employees. If employees were told that the first money coming out of a plan would be considered earnings and therefore be taxable, and that any taxable in-service withdrawal before age 59½ would be penalized, we believe most employees would reduce or eliminate their voluntary contributions.

The Council can see no reason for considering in-service withdrawals first as a return of earnings and then as a return of the employees' after-tax contributions. Also, the Council can see no justification for penalizing pre-age 59½ distributions.

There are over 250,000 qualified deferred profit sharing plans covering more than 14 million participants. Participation in qualified profit sharing plans covers a broad range of employees from the very highest paid to the lowest paid. Further, these plans cannot discriminate in favor of the higher paid employees. Any change in the method of taxation of in-service withdrawals would amount to a drastic change of a long standing provision in the law. The existing treatment has remained relatively unchanged for over 60 years. Employees would surely object strongly to any change in this long standing policy.

In taxing the income on employee contributions, the accounting provisions in most plans would have to be changed to specifically allocate earnings to the employees' contributions. This would amount to an additional administrative burden for plan administrators.

The Council urges the Committee to reject any proposals which would change the long standing tax treatment of non-deductible employee contributions from qualified profit sharing plans, or impose penalties on pre-age 59½ distributions. These proposals would adversely affect millions of employee participants.

Respectfully submitted.

WALTER HOLAN, *President.*

WASHINGTON, D.C., *February 28, 1984.*

Mr. JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR MR. SALMON: One of the changes made to the alternative minimum tax by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) will have an unintended adverse effect upon taxpayers who utilize the tax credit for alcohol used as a fuel (Sec. 44E of the Internal Revenue Code).

As you know, prior to 1980 motor fuel was exempt from the (then) 4-cent-per-gallon federal excise taxes on motor fuels if it contained at least 10 percent alcohol from sources other than petroleum, natural gas, or coal. However, no tax benefit was provided if blends of less than 10 percent were used, and no additional incentive was provided for fuels which contained more than 10 percent alcohol.

When the alcohol fuel credit was added to the Code in 1980, the basic intent was to give alcohol used as motor fuel the same tax benefit per gallon of alcohol whether it comprised less than 10 percent, 10 percent, or more than 10 percent of the motor fuel. Because the excise tax exemption reduces one of the blender's expenses which is deductible for federal income tax purposes (*i.e.*, his excise tax liability), an amount equal to this alcohol fuel credit was added back to income to produce the same result.

To ensure that the alcohol fuel credit did not insulate individual taxpayers from the alternative minimum tax, it was provided that the alcohol fuel credit could not be used to reduce an individual taxpayer's liability for the alternative minimum tax. However, since no tax benefit against this tax was obtained from the alcohol fuel credit, it was explicitly provided that an amount equal to the credit did not have to be included in income for purposes of computing alternative minimum taxable income. (See Sec. 55(b)(1)(B) prior to the TEFRA amendments.)

Without any discussion in the legislative history, TEFRA repealed this exclusion so that now, in computing alternative minimum taxable income, an amont equal to the credit must be included in such income even though the credit may not be used to reduce the alternative minimum tax. As indicated in the enclosed letter (and the examples attached thereto), there are situations in which a taxpayer's tax liability can be materially increased if he blends alcohol for use as a fuel or uses straight alcohol as a fuel. (Since the credit appears to be mandatory, this result probably cannot be avoided by failure to claim the credit.) For most blenders of alcohol fuels (except for major integrated oil companies), the alcohol fuel credit is likely to be very large in comparison with taxable income, computed without addition of an amount equal to the credit, and regular tax liability computed without regard to this income item or the credit. Consequently, situations in which a noncorporate taxpayer (particularly a small distributor) is materially worse off because of the tax credit could occur frequently if blends of other than 10 percent alcohol are used. Thus, because of the TEFRA changes to the alternative minimum tax, the alcohol fuels credit, which was intended to be an incentive to use alcohol in (or as) motor fuels, can be a powerful incentive *not* to do so. Since regular corporations are not subject to the alternative minimum tax, the effect of this TEFRA change is to impose a punitive tax on persons carrying on their business activities as proprietorships, partnerships and S corporations.

We strongly suggest that the TEFRA amendment to Section 55(b)(1) be reversed retroactively since it appears to have been inadvertent and has the potential for creating a substantial tax disincentive for an activity Congress wished to encourage. Given the nature of the change, we believe that it should be included in the technical corrections to TEFRA.

These comments are submitted on behalf of my client, the Renewable Fuels Association.

If we can furnish additional information, please contact me.

Sincerely,

ALVIN J. GESKE.

Enclosure.

DALBY, WENDLAND & CO., P.C.
Grand Junction, Colo., February 17, 1984.

Mr. AL GESKE,
Washington, D.C.

DEAR AL: This letter will follow-up our phone conversation regarding the changes made by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) to the alternative minimum tax as it relates to the alcohol fuel credit.

As you know, Section 44E of the Internal Revenue Code allows a credit for using alcohol in fuel or fuel blending by specified taxpayers. Section 87 (per-TEFRA Sec. 86) provides that an amount equal to the credit allowable is to be added to the taxpayer's income for purposes of computing income tax. These provisions were not affected by TEFRA.

Prior to TEFRA, the alternative minimum tax did not affect taxpayers utilizing the alcohol fuel credit. Sec. 55(b)(1)(B) (pre-TEFRA) provided that alternative minimum taxable income was gross income reduced by any amounts included in income under Sec. 86 or Sec. 667 (dealing with accumulation distributions of which we are not concerned). Thus, taxpayers were not penalized by the alternative minimum tax for utilizing the alcohol fuel tax credit which Congress enacted in 1980.

However, this exclusion had been eliminated by TEFRA. Revised Sec. 55 (b)(1)(C) dropped the reference to old Sec. 86 (now 87). As the following example will point out, taxpayers would be better off by not claiming the credit at all. However, a literal reading of Sec. 44E and 87 implies that the taxpayer may be forced to take the credit.

Our research of committee reports, editorial commentary, etc. found no discussion concerning the alcohol fuel credit and the interplay of the alternative minimum tax. As we discussed, the thrust of TEFRA and present mood of Congress is to penalize taxpayers for utilizing various credits and deductions to reduce their regular income tax liability. The change in Sec. 55 has succeeded only too well. It eliminates the benefit of these credits, imposes a higher tax than would normally be imposed if the taxpayer took no credit and finally defeats the Congressional intent of enacting Sec. 44E. This can be easily rectified by restoring the reference to Sec. 87 in Sec. 55(b)(1)(C).

Al, I enjoyed our conversation this morning and realize the difficulty in trying to get a change like this through Congress. Please contact me if I can provide any assistance through additional research, letters to specific legislators or joint committee staff members, etc.

Thank you for your consideration of this matter.

Yours truly,

EDWIN L. KREBS, CPA.

ALCOHOL FUEL TAX CREDIT AND THE ALTERNATIVE MINIMUM TAX

Assumptions: 1983 tax rates, married filing joint, no other items subject to alternative minimum tax.

CASE 1.—*Taxpayer claims no alcohol fuel credit*

Taxable income	$35,000
Federal income tax (rounded)	6,600

CASE 2.—*Taxpayer has $85,000*[1] *of allowable alcohol fuel credit and assumes pre-TEFRA wording of Sec. 55(b)(1)(C)*

Taxable income ($35,000 above plus $85,000 added per Sec. 87)	$120,000
Federal income tax	44,000
Alcohol fuel credit	−44,000
Net tax	0

There would be no alternative minimum tax since the $40,000 exclusion is greater than alternative minimum taxable income of $35,000.

CASE 3.—*Same as case 2 except current law applies*

Taxable income	$120,000
Federal income tax	44,000
Less alcohol fuel credit	−44,000
Regular tax due	0
Alternative minimum taxable income	$120,000
Less: Exclusion	−40,000
Total	80,000
Tax rate (percent)	20
Alternative minimum tax	16,000

Since the taxpayer pays the higher of the two taxes, regular ($0) or alternative minimum tax ($16,000), Case 1 provides the optimal answer. This appears to hold true in all cases where the alternative minimum taxable income is greater than $40,000. Given the limited life of any carryovers of excess credits (1994), it appears taxpayers may only benefit in low income years where they are not engaged in the alcohol fuel business (thus, avoiding the Sec. 87 addback).

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[1] $85,000 of credit is, in fact, quite small. It represents only the first six months of business of a new company. This could be $300,000-$500,000 in 1984 alone. If we assume $300,000 of allowable credit, the alternative minimum tax would be $59,000 as opposed to the same $6,600 of regular tax if no credits were claimed. Thus, the more successful the business becomes, the higher the penalty.

STATEMENT OF THE RISK AND INSURANCE MANAGEMENT SOCIETY, INC.

This statement submitted for inclusion in the printed record of the Tuesday February 28, 1984 United States House of Representatives on Ways and Means Committee's hearing on the Administration and other Proposals Concerning Tax Shelters, Accounting Abuses, and Corporate and Securities Reforms is submitted on behalf of the Risk and Insurance Management Society, Inc., commonly known as RIMS. The focal point of this testimony will be on the so called "premature accruals" mentioned by Secretary Regan in his February 1, 1984 Budget Briefing. RIMS is a nonprofit organization representing corporate and governmental self insurers and consumers of insurance in 77 chapters located throughout the United States and Canada. Corporate members include 90% of the top Fortune 1,000 list.

At this point one might ask: "What is risk management?"; "Who are risk managers?"; "Why are they so interested in "premature accruals?". Starting with the last question, it cannot be overemphasized that the subject of "premature accrual" is not merely an accounting issue as implied by Secretary Regan in his February 1, 1984 Budget Briefing, but rather an issue which impacts deeply on the freedom of a corporation to reduce costs by developing a stable self-insured funding mechanism to deal with predictable future losses. To restrict the ability of the self-insured corporation to deduct funds allocated on an accurate basis to pay these predictable losses would be to mandate inefficiency as a tax-policy goal and to ratify the tax inequity which already exists between the self-insured and commercial buyers of insurance. It would be in the best interests of the Treasury, the business community and potential claimants if Congress would direct its efforts toward equalizing the tax treatment of commercial purchasers of insurance and self insureds.

The following brief explanation of the risk management process will bring this issue into sharper focus. In the not too distant past, most corporations handled their business risks by relegating the purchase of insurance to a clerk. The clerk shopped around until he or she found what was hoped to be the right coverage at the most competitive price. Occasionally, a company purchased too much or too little insurance, but, in general, the corporation was adequately protected.

Unfortunately, as business risks escalated, it became more difficult to buy insurance to cover these exposures. Premiums for standard coverages have risen astronomically, and many insurance companies simply refuse to cover high-risk operations. It has been under these circumstances of growing corporate and governmental liability exposure that the field of risk management has evolved.

Risk management is the process of planning, organizing, directing and controlling the resources and activities of an organization to cost-effectively minimize the adverse effects of accidental losses on that organization. In the last 10 years, risk management has evolved from infancy to maturity, and many top corporations now give high priority to risk management programs.

As the role of risk management and its practitioners has grown, so has the status of the risk manager; from a clerk relegated to the purchase of insurance to an expert on risk identification, risk measurement and evaluation, risk elimination or reduction, and risk finance. Obviously, not all risk can be eliminated, and it is the risk manager's task to devise the most economically efficient means to deal with an organization's risk of loss. It is this process, risk finance, which is rapidly changing the insurance industry.

Today, an increasing number of corporations are financing a major portion of their losses internally, particularly when such losses are relatively frequent and predictable. "First dollar" insurance purchases in which coverage is obtained for the full extent of the loss, is becoming rarer. A brief example explains why.

A supermarket chain might find that its loss history over a 10-year period for "slip and fall" tort liability claims is relatively consistent, approximately $500,000 a year. The corporation could purchase "first dollar" insurance coverage which would cover the corporation for the full extent of its losses. However, this approach involves an expenditure by the corporation in the form of an insurance premium which exceeds the anticipated $500,000 loss, because the premium reflects not only the anticipated $500,000 in losses it intends to pay out, but profit and overhead as well. It is in this situation that the field of risk management comes into play to determine what type and percentage of risk that should be assumed internally and, similarly, to determine the type and percentage of risk that would be more economically efficient to handle through the purchase of commercial insurance.

One such technique is to establish a reserve for expected losses. This method acknowledges the existence of risk and creates a reserve on the balance sheet. The IRS has recognized this technique in Code Section 537(b)(4), which allows the acumulation of resonable product liability loss reserves, without subjecting the reserve to a tax on unreasonable accumulation of earnings. It should also be emphasized that the practice of maintaining a reserve plan is not only recognized but, in essence, mandated by the Financial Accounting Standards Board (FASB) in its FASB Standard Number 5 (FASB-5). FASB-5 states that highly predictable future payments arising from events that have occurred, including self-insured losses, are to be charged to income in the current period. This directive reflects FASB's concern that predictable losses should be reflected on the corporate balance sheet.

Under present law, the reserves set aside in the aforementioned supermarket example would not be deductible. It is only under the most limited circumstances that a taxpayer can receive a deduction for reserves set aside for self-insurance. As a practical matter, the landmark case in the area, *Kaiser Steel* v. *United States of America,* 82-2USTC9635 (N.D. Cal 1982) permits the corporate taxpayer a deduction only for amounts allocated to a self-insured workers' compensation reserve. In this case, the Court stressed that all of the events that bear on the fact of liability must have occurred in the tax year in which the taxpayer is claiming the deduction. The taxpayer in *Kaiser* was able to meet this test because workers' compensation is essentially a no-fault system in which liability is attached to the employer whenever an injury occurs in the workplace. Under very few circumstances other than workers' compensation, could the taxpayer claim a deduction. Moreover, the Court in *Kaiser* insisted that the amount of the liability must be determined with reasonable accuracy before the deduction could be taken. The taxpayer in *Kaiser* utilized the services of an experienced loss reserve specialist (much like an insurance company would in establishing the level of its own loss reserves) to determine what amounts would be required to meet its workers' compensation obligations in that year. This accuracy was not lost on the Court which noted . . . "We see that the amount of liability reserved proved to be accurate within 7 percent . . . and that to produce that modest inaccuracy Kaiser Steel under-reserved rather than over-reserved." Thus, in order to qualify for the deduction in *Kaiser,* the taxpayer had to prove that the amount set aside in the workers' compensation reserve reflected a sound computation and was not a number "pulled out of a hat".

Yet, it seems that the Administration proposes to legislatively take away the deduction permitted to the taxpayer in the legally sound *Kaiser* decision as a so-called "accounting abuse". RIMS most respectfully disagrees that the deduction allowable under *Kaiser* constitutes any kind of accounting abuse. As pointed out earlier, the taxpayer in *Kaiser* actually took less of a deduction than it was entitled to in that tax year. Furthermore, the Court made it clear that a taxpayer could not arbitrarily over-reserve in a workers' compensation loss reserve fund in hopes of obtaining a tax deduction. The amount set aside in such a workers' compensation fund must be determined with reasonable accuracy before the deduction can be taken. To arrive at such a reasonable estimate, it is virtually mandatory that the services of either a qualified actuary or loss reserve specialist be utilized by the employer in calculating its projected workers' compensation obligations in that year. That process is, in essence, no different than the one employed by traditional insurers in projecting their own loss reserves. And, as should be pointed out, amounts placed in an insurer's loss reserves are not taxable under the Internal Revenue Code.

Even if no such accounting abuse occurs, many on the committee may be considering this proposal in terms of its revenue enhancement potential. If that is indeed the case, then RIMS most respectfully submits that those members will be greatly disappointed. *Kaiser* applies to only the relatively few taxpayers who are eligible and do reserve their own workers' compensation fund. At best, the Treasury will get a one-shot acceleration of revenue flow as the timing of deductions claimed by self-insured corporations is postponed to coincide with actual payment or accrual of losses.

The cost to our economy, on the other hand, is a *permanent* loss of efficiency, because corporations will not be able to freely choose whether to self-insure or to procure commercial insurance based on economic considerations. Nullifying the deduction in the *Kaiser* case will create a situation where an employer who utilizes a traditional insurance carrier to provide workers' compensation coverage will receive a deduction while a self-insurer will not. Many self-insured employers who desire such a tax deduction may indeed switch, either totally or partially, to a commercial insurer. Logically, it may be more costly and less efficient for the employer to obtain coverage through a commercial insurer than it would be for that same employer to self insure. The employer's deduction for obtaining workers' compensation coverage from a commercial insurer is very likely to exceed that same deduction it was permitted to deduct as a self insurer. Large companies, which can and now do efficiently self-insure, will have a tax-motivated reason to behave inefficiently. This result makes a mockery of Treasury's claim that revenue enhancement should be based on tax equity. What could be further from equity than to subsidize inefficient and high-cost commercial insurance by disallowing deductions for all competing self-insurance funds?

Rather than further exacerbating the existing inequity towards self insurers in the Internal Revenue Code, RIMS urges this Committee to consider reforming the Tax Code to permit taxpayers who elect to self insure certain types of risks in addition to workers' compensation claims, the same tax treatment with respect to self-insured reserves, as if they had opted to purchase commercial insurance.

Congress, in permitting a deduction for insurance premium purchases, recognizes that protecting an entity from accidental loss is essential to sound economic planning. Congress, similarly, recognizes the importance of encouraging a stable funding mechanism through which claimants can receive just compensation. Yet, under our present system of taxation, the emphasis is placed on whether insurance is purchased or the risk transferred, rather than on the quality of the funding mechanism.

There are many sound policy reasons for amending the Code to permit a deduction for self-insurance reserving practices. From product liability to toxic waste, Congress and the courts have been enlarging the scope of corporate responsibility in almost every area. This has not been without ramifications. The greater the liability exposure, the higher the cost of securing commercial insurance coverage, if such coverage is available at all. These higher insurance costs are passed on to the ultimate consumer of the insured corporation's products and services. Moreover, the development of new products and services can be hindered because of excessive costs of insurance coverages for new risk exposures created by technological advances. Similarly, corporate funds are being devoted to securing insurance coverage at the expense of much needed capital investment. This, in turn, has a detrimental impact on the competitiveness of American industry.

Given the demands of the courts and Congress, a viable mechanism for self insurance is essential to deal with these enlarged loss exposures. A qualified self-insurance program permits the corporation to lower insurance costs which would otherwise be passed on to consumers. It encourages the development of new products and services by providing an affordable mechanism to insure against certain risks. It frees funds designated for insurance purchase for much needed capital investment. Most importantly, self insurance, in combination with the purchase of traditional insurance, allows the corporation to secure the broadest coverage at the least cost. Given these facts, it makes no sense to exclude qualified self-insurance reserves as a permissible tax deduction. As the reserves of the self insurer and commercial insurer serve the same purpose and are subject to the same claim liability, there is no rational reason for differentiating their treatment for tax purposes.

RIMS is keenly aware that the Committee is examining all legislative proposals with an eye towards revenue enhancement. Tax Code recognition for self-insurance reserving practices is not incompatible with this goal. That portion of the cost which the corporation will seek to deduct as self insurance would be lower than the deduction now obtained through the purchase of insurance, becasue neither the profit nor overhead of the insurance carrier is included. Thus, a lower deduction would be claimed by the self insurer than by his counterpart purchasing first dollar coverage. In addition, the amount saved by the self insurer is added to its tax base, providing additional potential revenue for the Treasury.

Moreover, wider use of self-insurance funding should enhance tax revenues because fewer deductible losses are incurred by the self insurer. An editorial in the trade publication *Business Insurance* (Nov. 22, 1982, page 8) stated, "It is quite clear from the experience in the United States that a company that pays its losses out of its own pocket in the first instance is more serious about controlling losses than the fully insured company." Companies that do self insure *are* aggressive about loss prevention, because the losses are felt directly on the corporate bottom line. Besides the tremendous benefit to society of fewer injuries and losses, the fiscal impact on the U.S. Treasury is clear. Fewer losses mean fewer deductions, and fewer deductions mean more tax dollars collected.

In determining how to implement an equitable tax policy for both insured and self insured, RIMS urges the Committee to consider the comprehensive approach taken by Rep. Frenzel in H.R. 2642, introduced on April 20, 1983. The legislation provides for a formal statutory arrangement whereby a taxpayer can comply with the *Kaiser* decision, but, in addition to workers' compensation liabilites, it would encompass reserves set aside for tort liability claims and fraud or defalcations incurred by financial institutions.

In order to qualify for the tax deduction under H.R. 2642, the loss reserve funds must be set aside in:

(1) A self-insurance trust which would be somewhat comparable to the trust arrangement that presently exists under section 501(c)9 of the Code and is used to provide coverages for certain employee benefit programs;

(2) A standby trust supported by an appropriate surety bond or letter of credit. This same approach was proposed in connection with certain environmental liability programs by the Environmental Protection Agency;

(3) Affiliated insurers which are your so-called captives. H.R. 2642 wording follows the definition for affiliated insurers found in the Federal Risk Retention Act; and

(4) Unaffiliated Insurers—These are commercial insurers which administer programs for the insured which contain substantial elements of self insurance.

The test for tax deductibility under an affiliated or unaffiliated insurer's program would be directly related to premium. Under a trust, it would be based on amounts determined in any reasonable manner that may be acceptable to the Secretary of Treasury. The bill also permits amounts to be set aside based upon determinations made by an independent and qualified actuary or loss reserve specialist. The amount set aside may also be based on an amount equal to 90% of what the taxpayer would have to pay a commercial insurer for coverage of the taxpayer's current liability for self-insured losses. This amount would be determined on the basis of a quotation from a licensed insurance carrier or brokerage firm.

There would be an annual recalculation of the liabilities covered by the trust at the end of each year to determine the adequacy of the deductions. In the event of a surplus, the excess in the reserve would be repatriated to the self insured and treated as gross income for tax purposes.

If the trust approach is used, the taxpayer's ability to terminate the trust is strictly limited. Termination is only permissible when:

(1) The taxpayer has not taken a deduction for losses self-insured through the trust in any of the five previous tax years;

(2) There are no outstanding claims of liability with respect to the risks the taxpayer self-insured through the trust;

(3) The applicable statute of limitations has run on all risks self-insured through the trust, or the risk is transferred to a licensed insurer.

These stringent termination conditions are designed to protect potential claimants by providing safeguards that the taxpayer will be around to pay loss claims when they become due.

In conclusion, RIMS urges this Committee to consider the approach taken in H.R. 2642 as a responsible solution to the needs of the public, American industry and the United States Treasury. It would provide the framework in the Tax Code for the *Kaiser* case to be implemented with certitude, consistency, and fairness by the Internal Revenue Service. It would encourage the formation of sound financial arrangements for the payment of potential claimants. It would eliminate the dysfunctional incentive to purchase potentially more costly commercial insurance to obtain a tax deduction. This would benefit the Treasury, as a lesser deduction for insurance would be taken by the corporate taxpayer than if it would have purchased commercial insurance. It would simultaneously benefit the business community, because it would free capital used for the purchase of insurance to meet vital operating needs and capital investment requirements.

A deduction taken for contributions to a self-insurance reserve is not an accounting abuse, but a recognition of economically sound and socially important risk management and risk financing techniques.

STATEMENT OF LEWIS H. SANDLER, GENERAL PARTNER, ON BEHALF OF SOUTHWEST REALTY, LTD.

This statement is submitted to the House of Representatives Committee on Ways and Means in connection with its hearing on Partnerships and Other Tax-Shelter Related Proposals and specifically in opposition to Mr. Pease's proposal to treat publicly traded partnerships or those with more than 100 members as corporations.

This statement is submitted by and on behalf of Southwest Realty, Ltd. ("SRL") a publicly traded limited partnership engaged in the acquisition, ownership, operation and selected disposition of income-producing real estate, its general partners and its investors, past, present and future.

SRL was created as a result of an exchange offer made by SRL to the limited partners of 23 limited partnerships in which SRL's general partners (three individuals and their corporate affiliate) were the general partners. The exchanging limited partners acquired their partnership interests in SRL in exchange for their partnership interests in their predecessor partnerships. Pursuant to a private ruling received from the Internal Revenue Service, SRL will be treated as a partnership rather than as an association taxable as a corporation. The ruling further stated that holders of SRL's depositary receipts (evidencing the economic attributes of SRL's limited partnership interests) will be treated as partners for federal income tax purposes.

In reliance on this ruling, hundreds of investors exchanged their partnership interests for interests in SRL. It would be a gross inequity to these investors, some of whom have held their limited partnership interests for up to 10 years, to convert, by federal legislation, the tax aspects of their state-chartered limited partnership interests. The effects of such conversion would be potentially devastating to these investors and to SRL.

Subsequent to the consummation of SRL's exchange offer, approximately one million depositary receipts have been purchased through the NASDAQ system or through the Pacific Stock Exchange. Such acquisitions have also been in reliance on the private rulings of the Internal Revenue Service. Similar inequities will be suffered by the holders of such securities if their partnership interests are converted for federal tax purposes by the proposed legislation into the equivalent of corporate stock.

The Pease proposal implies that publicly trading partnership are used to create publicly tradeable tax losses. This is patently false. A closer look at the publicly trading partnership such as SRL, Apache, May, Snyder and Newhall, to name a few, have been created as vehicles for the distribution of cash flow. Each of these publicly trading partnerships have distributed, since their respective inceptions, substantial amounts of cash. These partnerships are yield-oriented. They trade on a multiple of their distributions. SRL, for example, distributed $1.20 per limited partnership interest in 1983, its first year of existence. Its distributions to date in 1984 are being made (monthly) at the rate of $1.32 per annum per partnership interest.

As further proof of the inherent nature and economic value of these publicly trading partnerships, we invite your inquiry into the brokerage community. Prospective publicly traded partnerships have been consistently rejected by potential underwriters unless they (the prospective partnerships) have been able to demonstrate an ability to distribute cash flow on a consistent basis for a yield approximating 10% of the proposed initial offering price.

While it is true that partnerships pass-through certain losses, such as depreciation, to their investors, the publicly trading partnerships should not be designed as tax-shelters. The pass-through nature of a partnership is nothing more than one of many partnership attributes that distinguishes it from other business forms. These attributes have long been recognized under state law and in the Internal Revenue Code.

The average investor in a publicly trading limited partnership is purchasing his interests for their yield. The price being paid for such interests reflects such yield. We have seen no indication, to date, of any premium being paid by the investing public for the tax benefits. Nevertheless, such benefits are inherent in the partnership form of investment vehicle. There is no apparent logic in denying tax benefits to a partnership merely because its interests are publicly traded. There is even less logic in discriminating against a partnership because of the number of its investors. Logic and fairness would dictate that a uniform treatment be afforded all partnerships.

We wish to note that the Treasury Department has already testified in opposition to a similar proposal before the Senate Finance Committee. Ronald Pearlman, Deputy Assistant Secretary of the Treasury, in his oral testimony given before the Senate Finance Committee on October 24, 1983, opposed the classification of publicly trading limited partnerships as "associations taxable as a corporation". We applaud the Treasury Department's stand in this regard.

The very threat of Mr. Pease's proposal may have deleterious effects on the market price of all publicly trading limited partnerships, including but not limited to SRL. The uncertainty overhanging the trading markets in partnership interests warrants the prompt attention to and dismissal by the House Ways and Means Committee of this preliminary proposal to treat publicly traded limited partnerships as corporations for federal income tax purposes.

If there are abuses or loopholes in the current law, we support their correction. We are aware of numerous tax-shelter abuses that have been generated in recent years, many of them through the use of partnership structures. We are not aware, however, of any such abuses that have been generated through the use of publicly trading partnerships. To the contrary, the publicly trading partnerships have already subjected themselves to scrutiny by the SEC, NASD and/or a national stock exchange and, in some instances, by the various state blue-sky securities commissions. Further, publicly trading partnerships like SRL have presented themselves to the Internal Revenue Service for review prior to becoming effective. Accordingly, we submit that if any segment of the partnership industry is free from tax-sheltered abuse, it is the publicly trading partnerships.

If the current law harbors unintended hardships, we endorse suggestions that will effectively alleviate or eliminate such hardships. We do not believe, however, that the preliminary proposal of the House Ways and Means Committee to tax publicly trading limited partnerships will plug any loopholes; it may, however, give rise to additional, albeit unintended, hardships.

It is alleged that publicly trading limited partnerships are too similar to business entities that are taxed as corporations. There are statutory as well as real differences between partnerships and corporations. The Internal Revenue Service recognized such substantive differences when it issued private rulings to SRL and at least 5 other publicly traded limited partnerships (Apache Petroleum Company, May Energy Partners, Ltd., Newhall Investment Properties, Newhall Resources and Petroleum Investors, Ltd.). These partnerships and others have relied on rulings issued by the Internal Revenue Service. At the very least, neutrality and fairness require treatment of these existing partnerships and any new and additional partners in the manner already approved by the Internal Revenue Service.

The concept of neutrality, however, raises several questions. Why not tax all partnerships as corporations? Is it size that is offensive? If so, what about the billions of dollars raised each year by the publicly syndicated partnerships, many of which have thousands of partners. In fact, many of these partnerships each have thousands of partners more than do some of the publicly trading partnerships. Why not tax the royalty trusts, the real estate investment trusts and other publicly trading unincorporated entities as corporations? In fact, why not tax all publicly traded entities as corporations regardless of size, number of investors, statutory authority or consequences? Neutrality would also require that private partnerships be taxed as privately held corporations.

The concept of neutrality might also warrant the tax treatment of Subchapter S corporations as corporations. If size is the criteria, there are a number of Subchapter S corporations each of which controls billions of dollars of assets. The Treasury Department, however, has recently seen fit to expand rather than contract the number of entities that qualify for Subchapter S treatment.

Neutrality would also dictate a similar tax treatment for all partnerships. There is nothing magic about publicly-trading partnerships. If an entity is organized under the laws of a state as a limited partnership, it is a partnership regardless of whether or not its partnership interests are transferable or traded. Nor is there any magic in the number of investors holding partnership interests in a particular partnership. The number of investors in a partnership is not a criteria for qualification for status as a partnership under any state statute.

There is no justification under the law for affording separate entities organized and existing under the same state statute different tax treatment. The unfairness of such approach is obvious. SRL was formed under the Texas Uniform Limited Partnership Act. So too were its predecessor partnerships that have in effect merged into SRL as a result of the exchange offer. The Pease proposal would have the effect of substituting free transferability as the sole criteria for taxation of an association as a corporation in lieu of the four criteria heretofore established by the Internal Revenue Service and the courts for such treatment.

Generally, such a radical departure from established rules and procedures would be preceded by in-depth studies and careful deliberation. Even then, drastic changes are generally adopted only where there are compelling reasons to do so. We have neither seen nor heard of any compelling reasons to tax any partnerships, let alone, publicly traded ones, as corporations. In fact, the issuance by the Internal Revenue Service, within the past two years of a number of private rulings to the effect that certain of the publicly-trading partnerships would be treated as partnerships for tax purposes, would suggest that the Internal Revenue Service is not aware of any compelling reasons to treat publicly-trading partnerships any differently than other, non-trading partnerships. We believe that the Pease proposal regarding publicly-trading partnerships suffers somewhat from a lack of consistency and careful analysis.

Free transferability, in and of itself, is not dispositive of the question of taxability. Many partnerships provide for the free transferability of their partnership interests. In fact, to qualify for investment under ERISSA, partnerships are required to provide for such free transferability. Such partnerships are no different, in concept, purpose or operation, than are those whose interests are not only freely transferable but are also trading. Neither the law nor logic dictate a different tax treatment between partnerships whose interests are tradable and may be trading on a limited basis from those whose interests are trading on an active basis.

Southwest Realty was conceived and formed as a growth vehicle. It has the ability to raise equity and/or debt from either the public markets or from private placements. It was designed with maximum flexibility to draw from such markets in order to maximize its ability to raise new funds at the lowest possible cost. Clearly, if the proposed legislation is adopted, our ability to issue additional partnership interests will be severely hampered, if not curtailed.

Without the availability of new funds from time to time, SRL will find it difficult, if not impossible, to acquire or develop new income producing real estate properties. Since most of our portfolio is comprised of multi-family, rental housing projects, our ability to provide new rental housing will be severely impaired. In fact, the mere threat of the proposed legislation has contributed to the deferral of an offering that was on the verge of being filed. Such offering would have been the cornerstone for our development and/or acquisition of new multi-family rental housing projects. The form of a publicly trading limited partnership is well suited to encourage further development of multi-family rental housing projects by SRL and others. We believe that the proposed legislation regarding publicly trading partnerships will stifle and discourage such development throughout the United States.

Who are our prospective investors? Are they the affluent who are seeking highly leveraged, tax sheltered investments in order to avoid or defer the payment of taxes? Our Partnership has a portfolio of existing income-producing properties in connection with which we are currently distributing on an annualized basis $1.32 per depositary receipt. Generally, we believe that our investors are seeking a reasonable return on investment and a hedge against inflation.

We urge the House Ways and Means Committee to withdraw its proposal to tax publicly trading partnerships as corporations. We respectfully request that such action be taken forthwith to remove any clouds that may have been inadvertently created over the trading of limited partnership interests. We thank the Committee for its early consideration of this matter.

STATEMENT OF JAMES C. THOMPSON, ST. LOUIS, MO.

One of the apparent abusive tax shelter and income tax loopholes currently being used by promoters to reduce and to defer payment of income taxes by the affluent taxpayers and boomeranging as a current tax burden on the backs and pocketbooks of low and moderate U.S. wage earners, is by and through real estate limited partnerships involving non-recourse loans and "at-risk" rules.

Subsection 465(c)(3)(D) IRC specifically exempts such real estate tax shelters from the "at-risk" rules and allows such limited partnerships under Section 168 IRC to write off buildings over a statutory life of only 15 years as compared with the historical economic useful average life of 45 years.

With the exception of two activities not subject to the "at-risk" rules, namely real estate activities and the leasing of equipment by closely held corporations as provided by IRC Code 465(c)(3)(D) and (c)(4), the "amount-at-risk" rules of Code Sec. 465 generally limits an individual, subchapter S corporation and personal holding companies losses and depreciation deductions to the amount that these taxpayers have "at-risk" and could actually lose.

The "at-risk" rule is designated to prevent taxpayers from offsetting taxable income through tax deductions from investments in activities that are largely financed by non-recourse loans and indebtedness for which the taxpayers are not personally liable.

It is generally under the permissiveness of Subsection (c)(3)(D) 465 IRC, that partners of a Real Estate Limited Partnership are permitted to use and consider non-recourse loans, indebtedness and liabilities as part of the capitalized adjusted cost basis of buildings and improvements for the calculation of tax deductions for depreciation charges and losses from such activities.

Historically, taxpayers have been permitted to recover the cost of their investment in business real estate and improvements through depreciation deductions over a period of time designated to represent a reasonable allowance for the exhaustion, wear and tear of such properties.

Under Revenue Procedure 62-21, as in effect on December 31, 1970, buildings were depreciated or written off over 40 years for apartments, 50 for banks, 45 for dwellings, 45 for factories, 40 for hotel and theaters, 45 for office buildings, 50 for stores and 60 for warehouses.

Congress was convinced that all historical depreciation tax rates and systems were not adequate to provide a sufficient incentive for economic growth; that the system had grown too complicated and that depreciation rates and the dollar amount of depreciation taken were usually subject to question upon audit.

To correct these purported problems, the Economic Recovery Tax Act of 1981 (ERTA) added the Accelerated Cost Recovery System (ACRS) and the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and modified the ACRS provisions enacted by TEFRA, whereby business machinery and equipment in general are depreciated over new statutory recovery lives of 3 years, 5 years and 10 years for public utility property.

For business real estate, buildings used in a trade or business or held for the production of income and placed in service after December 31, 1980, the above stated new statutory depreciation rule permits the purchase price or unadjusted cost basis of such buildings (which usually include non-recourse loans and indebtedness therefore) to be depreciated and written off over a statutory period or elected life of only 15 years as compared with the old historical lives under Revenue Procedures 62-21 averaging 45 years.

The permissiveness of Subsection 465(c)(3)(D) and 1981 ERTA and 1982 TEFRA encourages promoters, speculators and affluent investors in real estate tax shelter limited partnerships to take losses and tax deductions for phantom non-funded paper depreciation deductions and losses on buildings being financed with "non-recourse" loans and indebtedness and to charge off these buildings over a period of only 15 years; furthermore, to increase the "tax shelter opportunities" contrary to that intended by the Tax Reduction Bill of 1980 for taxpayers to seek subterfuges in overcoming the prohibitive "anti-churning rules" applicable to real or personal property in use before 1980 or as detailed in the July 22, 1981 report of the House Ways and Means Committee Tax Incentive Bill of 1981.

In many instances old depreciated office and commercial buildings in service before December 31, 1980 are and have been acquired by tax shelter promoters who after applying some "cosmetic" improvements thereto, have sold or "churned over" the buildings at inflated values to real estate tax shelter partnership solely for the purpose of peddling phantom or paper depreciatin tax deductions on "non-recourse" loans and indebtedness.

Currently and within recent years comparatively new bank, office and other buildings are being offered for sale or have been sold at considerable tax deferred installment gains and financed by "non-recourse" loans by promoters of real estate limited partnerships solely for their general and limited partners obtaining "jacked-up" paper depreciation tax deductions and "shaped solely by tax avoidance features" and apparently contrary to the judicial reasonings of the U.S. Tax Court and other prior year court decisions.

It is important to note that the September 15, 1980 report of the Senate Finance Committee Covering the Tax Reduction Bill of 1980 (HR 5829) endeavored to correct and limit some of the permissiveness of Subsection (c)(3)(D) of Sec. 465, when it stated regarding the depreciation of real property:

"(65)" The Committee believes that the rates for depreciation of real property should be revised to provide more simplicity and more accelerated depreciation than is currently available. These goals, however, must be achieved without increasing tax shelter opportunities";** (p. 66) "For qualified owner-occupied industrial and commercial buildings, a taxpayer may elect to depreciate the property over a 15 year period" * * * (p. 67) "In general, the term "qualified use" means use by the taxpayer as industrial buildings, retail store or catalog distribution center. Under the bill, an industrial building is a building or structure used for manufacturing, production or extraction or the forwarding of transportation activities of the taxpayer. Office buildings, retail stores, public utility property (Sec. 167)(1)(3)(A) and certain warehouses and storage areas are not industrial buildings under the provision of the bill"; (p. 68) "Under the bill a building is not owner-occupied if any person other than the taxpayer is entitled to claim depreciation deduction with respect to such buildings" * * * "If the buildings are owned by an individual and used for a qualified use by a partnership in which the individual is a partner, the buildings will not be considered owner-occupied" * * * "If an election is made to depreciate a qualified owner-occupied building under the new 15 year method, the gain from the depreciation of the property will be subject to ordinary income recapture in accordance with Code Sec. 1245" (p. 69) "It is estimated that this provision will reduce budget receipts by $45 million in fiscal year 1981, $161 million in 1982, $256 million in 1983, $298 million in 1984 and $326 million in 1985.

It is important to note the following tax cases determining the real owner of real estate and who has the right to deduct depreciation and losses on said property; see the *Frank Lyon Case (75-2 USTC #9545)* wherein the district court held that Lyon was in fact the owner of the property because he was the only borrower and sole obligor, reversed by the Court of Appeals for the Eighth Circuit (76-1 USTC #9451 536 F 2d 746 CA8) and the 8th Circuit opinion reversed by the U.S. Supreme Court (435 U.S. at 576) stating that Lyon alone was personally liable on the notes and the transaction was "not shaped solely by tax avoidance features". See also tax case of *Carol W. Hilton (74 TC 305 (1980) aff'd per curiam (82-1 USTC #9263-671 F 2d 316 CA9)* wherein the Tax Court concluded that a limited real estate partnership of which the taxpayer was a limited partner had no real potential for economic profit and that the sole purpose of the investors involvement had been to obtain tax deductions and could not deduct losses resulting from depreciation and interest due to the fact the investors were not the real owners of the property.

Who are the taxpayers taking advantage of the permissive exceptions to the "amount-at'risk" rule as provided by Sec. 465(c)(3)(D) IRC, permitting the use of non-recourse loans, mortgages and indebtedness in financing such buildings, taking advantage of non-funded paper depreciation tax deduction thereon over a statutory life of only 15 years as compared to historical useful lives of 45 years, taking advantage of the current liberal tax benefits of Limited Partnership Real Estate Tax Shelters—all of which tax advantages shift the current tax burden and deferrment of income taxes by certain affluent taxpayers to the backs and pocketbooks of the low and moderate U.S. wage earner? It certainly is not the low and average moderate U.S. wage earners and taxpayers who comprise the majority of our present individual paying taxpayers.

For a simple example two affluent individuals filing joint income tax returns, each with ordinary net taxable income of $300,000 consisting of salaries, dividends, interest and other ordinary income, at 1983 tax rates each would have a total income tax due and payable of $134,000.

By forming and investing in a Real Estate Limited Partnership it is possible for these two taxpayers to save and shelter and defer such income taxes:

(1) By purchasing a building for	$10,000,000
(2) Each Investing $500,000 for a total cash down payment of	1,000,000
(3) By having their Limited Real Estate Partnership issue a non-recourse mortgage for the balance due per the permissable provision of Sec. 465(c)(3)(D) for	9,000,000
(4) By paying out of the estimated annual $2,650,000 Rental Income after Principal payments—all Operating Expenses Totaling $2,639,000 (such as interest expense, real estate taxes, operating cost) leaving a net operating profit before deducting book charges for buildings depreciation of	11,000
(5) Less provision for building depreciation charges:	
(a) on actual "amount-at-risk" cash invested $1,000,000 divided by 15 years equals	(67,000)
(b) Net book loss on actual "at-risk" investment	(56,000)
(c) Book depreciation charges on "non-recourse mortgage" $9,000,000 divided by 15 years	(600,000)
(6) Total tax loss reportable by Real Estate Tax Shelter Limited Partnership and allocated $328,000 to each limited partner	(656,000)
(7) Total Net Taxable Ordinary income for each taxpayer per above	300,000
Less each taxpayer's portion of $656,000 Real Estate Tax Shelter Limited Partnership Loss	(328,000)
Net Taxable Loss for each taxpayer after above book depreciation deduction	(28,000)
(8) Resulting in a tax savings or deferrment of income taxes for both taxpayers totaling	268,000

With current publication reporting there are some 800,000 all told who will ante up about $12 billlion before the year 1983 is over in supposedly sure-fire real estate tax shelter deals, that tax shelters are selling nearly twice last year's rate; that about 334,000 shelter income tax returns are now under examination or double the number in 1980; that a record $3.3 billion poured into publicly registered partnerships in the first nine months of 1983, 106 percent from last year's pace; that by the end of 1983 public syndicators are expected to have attracted close to $4.5 billion in new investment funds, up from $2.7 billion in 1982; that present syndicators are pulling in perhaps as much as $20 billion largely from individuals and with the vast majority of individual taxpayers being the average U.S. low and moderate wage earners who cannot afford such tax shelter investments, it, therefore, does not take much imagination or vision as to which taxpayers are taking advantage of these non-recourse tax shelter real estate limited partnerships and shifting their present tax obligation onto the backs and pocketbooks of the low and moderate U.S. wage earners as a whole.

Furthermore, multiplying the above cited $134,000 tax savings or deferment of income taxes per the above hypothetical example times the potential number of taxpayers taking advantage of the specific exemptions permitted by Subsection (c)(3)(D) 465 IRC and the 15 year depreciation being allowed on phantom book depreciation charges on "non-recourse" mortgage loans and indebtedness, should more than approximate the $8 billion in new revenue over three years as requested by House Bill (HR 4170) and which the House recently blocked passage.

Neither the September 27, 1983 Preliminary Report of the Staff of the Senate Finance Committee nor the House Blocked passage of the proposed Tax Reform Bill of 1983 (HR 4170) appears to contain any corrective provisions covering the permissive tax shelter loophole found in IRC Subsection 465(c)(3)(D) permitting tax shelter real estate limited partnership's phantom depreciation tax deduction on "non-recourse" loans, mortgages or indebtedness and the depreciation of said "non-recourse" amounts over a statutory period of only 15 years.

It is high time that Congress give special attention to correcting the permissive provisions of Subsection 465(c)(3)(D) IRC permitting Limited Partnership Real Estate tax shelters to include non-recourse loans, mortgages or indebtedness as part of the adjusted cost basis of buildings and depreciating such buildings or non-recourse loans life of only 15 years to the apparent detriment of not only the low and moderate U.S. wage earners but to all individual taxpayers as a whole.

Until Congress sees fit to close certain of the permissive tax loopholes presently available to promoters and affluent taxpayers under the current provisions of Subsection 465(c)(3)(D) and to limit the non-recourse provision solely to "qualified owner-occupied industrial and commercial buildings" as set forth on pages 66, 67, and 68 of the September 15, 1980, Report of the Senate Finance Committee covering the Tax Reduction Bill of 1980 (HR 5829), the IRS hands in this respect appear legally tied.

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